

JUNE 1961

VOL. XXXI NO. 6

The President's Page

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**THE NEW YORK**

**Certified Public Accountant**

June 1961

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## Accounting News And Trends

### IMPROVEMENT IN N. Y. STATE'S ACCOUNTING POLICIES

In a recent statement, Arthur Levitt, Comptroller of the State of New York, described the new program designed to improve the State's accounting system. The basic objective of this program is to modernize and simplify the accounting of state government and, to achieve this goal, Mr. Levitt states that a two-pronged survey program will be undertaken.

A primary survey will be made of the existing central accounts within the Department of Audit and Control to evaluate, (1) the adequacy of existing records maintained, (2) the type of information shown on these records, (3) the use or purpose for which the records are maintained, and (4) whether the existing system provides the most meaningful, timely and accurate accounting information.

A secondary survey will be made of the other departments and agencies to determine the same factors and, additionally, what other financial information management it feels it needs to carry out its duties.

The information gathered in these surveys will be analyzed and appraised in the light of modern accounting

principles and methods, the legal requirements of the State, and the current and anticipated informational needs of all levels of State government. It is anticipated that, as the result of these studies, the recommended modification and revision of the existing central accounting will be implemented by the Department of Audit and Control and the other state departments and agencies.

In conclusion, Mr. Levitt stated:

"The magnitude of State expenditures makes it more and more important that we seek every reasonable means of obtaining full value for each taxpayer's dollar spent. I believe that the accumulation of sound accounting information, the proper interpretation and evaluation of this information and timely reporting to all interested parties will provide adequate assurance that the taxpayers are getting full value for their dollar."

### PENALTIES ON TAX EXAMINERS

A comment appearing in *Accountancy*, December 1960 (Great Britain) concerning "penalties on the other side of the fence," points out that penalties also apply to Inspectors of Taxes. Thus, an Inspector of Taxes incurs a penalty of £100 (\$280) for each offense, and on conviction is to be discharged from office if he is guilty of some of these offenses:

Willfully makes a false or vexatious surcharge of tax; or willfully delivers or causes to be delivered to the General Commissioners a false or vexatious certificate of surcharge or a false or vexatious certificate of objection to any supplementary return in a case of surcharge; or knowingly

---

**Accounting News and Trends is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Accounting Procedure and is Program Director of the Brooklyn Chapter of the National Association of Accountants. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College. He is also professor of taxation at the New York Law School.**

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or willfully, through favour, undercharges or omits to charge any person; or is guilty of any fraudulent, corrupt or illegal practices in the execution of his office.

The word "vexatious" is intriguing; a well-known dictionary interprets the word as meaning vexing or annoying.

## ELIMINATING SUB-STANDARD REPORTS

In his article on "Banker-CPA Cooperation" (*The California CPA Quarterly*, March 1961) Mr. Maurice J. Dahlem concentrates his attention on what is being done in his own state to insure better relations between bankers and accountants.

As a result of continuing complaints and a number of violations on the part of CPAs and PAs which came to the attention of the State Board of Accountancy, The California Society of CPAs decided a few years ago that it should endeavor to ascertain (1) the extent of the violations, and (2) whether or not the offenders are members of the Society. To that end arrangements were made to undertake a survey of audit reports in the credit files of certain major banks in California to ascertain whether they conform to Rule 58 of the State Board of Accountancy and rules of the AICPA concerning the expression of an opinion on financial statements. These are the rules that make it incumbent upon the independent CPA, rather than upon the user of the report, to evaluate the propriety of the accounting principles reflected in the statements and the adequacy of the auditing procedures.

Fifteen hundred reports in which CPAs gave unqualified, qualified, and disclaimed opinions, and 150 "prepared without audit" reports were selected at random from the files of the cooperating banks. Since these banks

keep central files in San Francisco or Los Angeles for loans made in outlying areas, it was believed that the statistical sample of 1,650 reports covering loans made in all portions of the state was representative of the overall picture.

Preliminary tabulations of the questionnaire have been completed. While the research director has not analyzed the results, he recently indicated: "Preliminary results look quite favorable. Indications are that there will be less than 3% noncompliance in the case of the audit reports. The 'prepared without audit' reports do not look as good. Over 10% of these reports did not include the phrase 'prepared without audit' or similar wording. In addition, approximately 25% of these reports had 'prepared without audit' on the covering letter only."

The author concludes that results so far indicate that the accounting profession as a whole is doing a relatively good job in complying with Rule 58 in cases where opinions are being given. However, CPAs cannot be complacent about the quality of work because sub-standard work could have been done even though the report is correct. Furthermore, the small sample of "prepared without audit" reports indicates that this is an area to which some educational efforts should be devoted.

#### DECIMALIZATION OF ENGLISH CURRENCY

Any CPA who has struggled with the pounds, shillings and pence of the British monetary system will welcome the formal recommendation of the Council of the Institute of Chartered Accountants in England and Wales to the Chancellor of the Exchequer that decimalization of the currency be adopted, (*Accountancy*, Feb-



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ruary 1961). By 1965, the United Kingdom will be the last significant upholder of the present British system since all of the other commercially advanced nations of the Commonwealth will have abandoned it. Although fully recognizing the problems and costs of conversion, the Council's report concluded:

"(a) decimalization of the currency should be officially adopted in principle and widely announced for introduction at a specified date, being the earliest date consistent with an adequate preparatory period

(b) the most appropriate basis for decimalization in this country is the 'ten shilling/cent' system with one hundred cents equal to the present ten shillings and the halfcent as the smallest unit, which would be approximately equivalent to the present half-penny."

### **IMPROVING ANNUAL REPORTS**

*Preparing The Annual Report*, Research Study 46 of the American Management Association, (\$3.00 for members; \$4.50 for non-members) contains many ideas to assist the accountant in improving the presentation of the material in the report. An accountant will find informative the first part of the study which tells how some 278 companies have assigned executive authority and set levels of responsibility for key steps in planning, preparing, and approving the report, but he would probably turn quickly to the second part.

Part II of this study concerns itself with the actual contents of the report. Unlike *Accounting Trends and Techniques*, a publication of the American Institute of CPAs which emphasizes the applications of accounting principles, this section concentrates on how to achieve readability, including the techniques for presenting high-



lights of activities. Some 100 company reports are analyzed and compared, and worthwhile presentations from many of them are reproduced in full.

#### A NEW ACCOUNTING MAGAZINE

With the publication of *The Florida Certified Public Accountant* for May, 1961 a new professional monthly magazine has appeared on the accounting scene. Since the number of Florida CPAs has increased from 513 in 1951 to over 1,500 at present, it is appropriate that the Florida Institute of CPAs should make this contribution to accounting literature. In its 37 pages the first issue covers an interesting range of topics and the statement by the Institute's president that "We are confident that *The Florida Certified Public Accountant* will eventually be rated among the best accounting publications issued by state societies . . ." might well prove to be an accurate prophecy.

One of the articles reports on the present status of the Florida ethics examination which has been adopted as a permanent part of the application procedure for taking the CPA examination in Florida. This idea has received widespread interest and approval throughout the profession. At the present time some sixteen or more states, from Massachusetts to New Mexico, have requested additional information from the Florida State Board of Accountancy regarding this innovation. Some of the states have already adopted an ethics examination in connection with their CPA examination applications.

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## Letters to the Editor

### CLASSIFICATION OF UNION OFFICERS' EXPENSES IN LABOR UNION ANNUAL REPORTS TO THE N. Y. STATE DEPARTMENT OF LABOR

There are thousands of labor unions, including individual locals, in the State of New York. Each of them must file with the N. Y. State Department of Labor an annual report which includes a statement of receipts and disbursements. Many certified public accountants may be called on to assist in the preparation of these reports; therefore the following correspondence, slightly abridged to eliminate irrelevant material, should be of interest to them.

Incidentally, these communications point up the increasing cooperation between our Society and various governmental agencies that are concerned with accountings.

A letter sent to me, in my capacity as Chairman of the Society's Committee on Labor Union Accounting, by Harry J. Kallet, Chief Accountant, Division of Labor and Management Practices of the State of New York Department of Labor, solicited our Committee's views on the classification of union officers' expenses for reporting purposes. The following is the subject correspondence.

ISIDORE PLATKIN, CPA  
(Tunick & Platkin)  
New York, N. Y.

February 28, 1961

Dear Mr. Platkin:

In accordance with our telephone conversation of this afternoon, I would appreciate it very much if you would consider placing the following on the

agenda at the next meeting of the Committee on Labor Union Accounting:

The Labor and Management Improper Practices Act, Section 726, subsection 1.(b), indicates that the reporting organization must include on the report the compensation, allowances, and expenses of each of its three principal officers.

It is my opinion that the "expenses" mentioned above refers to both reimbursed expenses and expenses paid either by means of credit cards or other credit arrangements. I believe that any expenses, such as hotel and travel, of an officer attending a convention should be included on the report as being allocated to the particular officer attending that convention, even though he did not actually handle any of the funds.

I would appreciate hearing from you as to the viewpoints of the members of your Committee as to the type of expenses they believe should be included on the report as filed by a labor organization.

HARRY J. KALLET  
Chief Accountant

March 11, 1961

Dear Mr. Kallet:

As I promised you during our telephone conversation, interpretation of the term "expenses," for purposes of the Labor and Management Improper Practices Act has been placed on the agenda for my next committee meeting.

I should like to anticipate one question which may come up; whether your own interpretation is intended to

be the same as that used by the U. S. Department of Labor in its instructions for form LM-2. I refer particularly to the fourth page of the LM-2 instructions, under the category of Disbursements which explain what should be included as expenses in schedule F.

ISIDORE PLATKIN, CPA  
Chairman, Committee on Labor  
Union Accounting

March 13, 1961

Dear Mr. Platkin:

Reference is made to your letter of March 11, 1961. Please be advised that my own interpretation is intended to be the same as that used by the United States Department of Labor in its instructions for Form LM-2.

HARRY J. KALLET  
Chief Accountant

April 28, 1961

Dear Mr. Kallet:

My committee has considered your letters of February 28, 1961 and March 13, 1961 at its meetings held on March 20th and on April 26th. Your letters deal with the interpretation of "expenses" to be shown as those of a particular officer of a labor organization on reports filed with your Department under the Labor and Management Improper Practices Act.

In our discussions we utilized the following material:

a. The Labor and Management Practices Act, particularly Section 726.

b. Your Department's Form LP-2.

c. Instructions relating to this form.

In view of your letter of March 13th and in view of the fact that

federal Form LM-2 may be submitted in lieu of pages 2 and 3 of your Department's form, we also considered the corresponding federal material consisting of:

a. Labor - Management Reporting and Disclosure Act of 1959, particularly Section 201.

b. Federal Form LM-2.

c. Instructions relating to this form. It is the feeling of my committee that:

1. The Labor and Management Improper Practices Act is broad enough to permit your interpretation of "expenses."

2. The requirement that such expenses be reported is reasonable and justifiable for the purpose of carrying out the intent of the law.

3. A satisfactory definition of expenses to be reported as those of a specific officer or agent should be those incurred by or for him, or reasonably allocated to him, regardless of whether they were paid directly by the organization, or paid by the individual or someone else and reimbursed by the organization.

4. Your Department's form appears to create certain difficulties and ambiguities. Line 123 calls for "Allowances for travel and related expenses." The corresponding instructions refer only to "expenses" and not to "allowances." Line 124 calls for "Allowances for other purposes." It therefore is not clear whether expenditures for travel and related expenses should be placed in a separate category from those for other purposes, or whether allowances should be separated from expenses.

5. Item 224 adds to the confusion because here allowances and expenses are to be reported separately, although possibly combined on Line 123.

6. The instructions for Item 224 of the report permit misinterpreta-

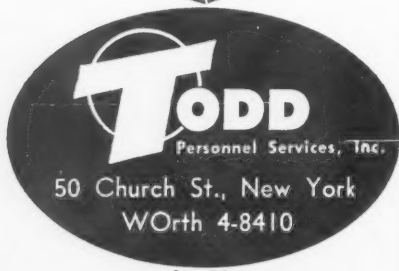


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tion. These instructions refer to "expenses incurred for the benefit of the officers or agents." A literal, but apparently unintended interpretation of this instruction might result in the inclusion only of expenses for the personal benefit of an individual, such as the cost of a paid vacation, and the exclusion of expenses incurred in the course of official business.

7. Neither your instructions for Item 123 nor those for Item 224 define "expenses" as explicitly as do the federal instructions relating to Column E, Schedule F of the federal form.

8. The information called for on Lines 123 and 124 should follow Line 120 so that all payments to or for officers, staff and agents will be on consecutive lines.

The views expressed above are solely those of the members of my committee and are not intended to be the official views of our Society nor our membership as a whole.

My committee appreciates the opportunity of working with you on this matter. We hope you and your Department will continue to call on us whenever we can be of assistance.

**ISIDORE PLATKIN, CPA**  
Chairman, Committee on Labor  
Union Accounting

May 3, 1961

Dear Mr. Platkin:

Thank you for your letter of April 28, 1961.

I would like to express my gratitude to you and the members of your Committee on Labor Union Accounting for the assistance given to this Division.

Your comments and suggestions relative to various items in the Divi-

sion's Form LP-2 and the instruction booklet are sincerely appreciated.

HARRY J. KALLET  
Chief Accountant

#### STILL MORE ON AUDITING BANK DEPOSIT SLIPS

Do you mind if I get in on the act regarding auditing of bank deposit slips?

I share the views of those who feel that a bank stamped duplicate slip is no real assurance. At the time of the Coster-Musica (McKesson Robbins) Case, I made a study of employee frauds on behalf of the Society. It was my conclusion that the way to put an end to lapping, and any other fraud that depended on falsifying the source of deposits, is through what I call the controlled duplicate deposit slip.

Here is the procedure I recommend: (1) The bookkeeper makes the deposit slip in duplicate. (2) On the duplicate the bookkeeper records the details of the deposit; that is, the name of check payors and the accounts to be credited. (3) The slips and the underlying deposit documents are taken to someone in the organization not connected with bookkeeping. That someone compares the ingredients of the deposit with the duplicate detailed deposit slip. (4) The original deposit slip and the checks to be deposited are then given back to the bookkeeper, while the detailed duplicate deposit slip is retained for the auditors, internal or external. (5) The bookkeeper makes the deposit, without asking the bank to stamp or confirm anything.

Lapping can never get off the ground with such simple procedure. The bank stamped duplicate provides no such results.

J. S. Seidman, CPA  
(Seidman & Seidman)  
New York, N. Y.

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ANOTHER VIEW ON CPA  
EXAMINATION REQUIREMENTS

As chairman of the Council on Accountancy and of the special committee appointed by the License Committee of the Board of Regents, I was very much disturbed by the letter from Professor Arnold W. Johnson which appeared in the April issue of *The New York CPA*. A discussion of the matter with Professor Johnson elicited the information that his major concern was that "no significant change should be made operative in the requirements which qualify a man to sit for the CPA examination unless this change has been approved by the profession of CPAs of the State of New York." In this particular case this could not be done, as the committee was restricted as to the publication of the report.

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The original draft of the report was circulated to nineteen educators and their replies showed a considerable divergence of viewpoint. The committee could not possibly have reconciled these viewpoints. However, it took them into consideration in the report which was issued to the License Committee last October. Contrary to the impression of many who have not seen the report, the recommendation as to a fifth year was that it should be optional and would be in lieu of one year's experience.

The report submitted was approved by the Council on Accountancy as well as by the Board of Examiners. These two groups include three educators, several past presidents of the New York State Society and others who have been quite active in the affairs of the Society. I have little doubt that the report would receive substantial endorsement by the members of the Society if it had been appropriate to submit it to them.

Having served on the Board of Examiners, the Council on Accountancy and in various positions in *The New York State Society*, I have had some knowledge during the past years of the inability of the educators and the profession to reconcile some of their viewpoints as regards education for the accounting profession. I have hoped for several years that the two groups could get on the same "wave length" with regard to education for the accountant, but to date this has not been realized. It is my distinct impression that this arises in great part due to the differences in viewpoint of the educators as to a curriculum which they would support.

ALDEN C. SMITH, CPA  
(Chairman, Council on Accountancy  
The State Education Department)  
New York, N. Y.

## THE PRESIDENT'S PAGE

The medium of this page enables me to address myself to each member of our Society, individually, in his home or his office, wherever he peruses this magazine. Moreover, this medium permits me to meet many more members and fellow practitioners than I could possibly meet by any other means. So, I happily seize this first opportunity, to express to all of you at the very outset of my administration, my thanks for the great honor that you have bestowed on me, to have chosen me as your chief executive for the ensuing year. You may be sure that your trust will command my constant concern, and that the goodwill of our Society and its steady advancement will receive my fullest and most faithful attention.

Through the medium of this page I will discuss with you the current problems of significance to our Society and to our profession. You are sincerely invited to communicate with me on any of the matters discussed, to give me your views and suggestions. This will help me to feel the membership pulse and should be most helpful in the formulation of policies and decisions. Please write.

### INCORPORATION OF THE CPA PROFESSION

A recent development in this country that is of interest to accountants is the enactment of laws which permit members of a profession to practice as corporations. Laws have been passed in South Dakota and Arkansas permitting doctors and dentists to do so. Similar bills have been introduced in several other states, in some instances extending the provisions to include all professions. In the 1961 session of the New York State legislature a bill was introduced permitting the members of any profession (including public accountancy) to practice as a corporation; it died in committee.

To one who has lived his entire professional life under the convention that a profession should be denied the corporate form of organization, the move to remove this prohibition seems like a heresy. This reaction, however, is the result of years of unquestioned acceptance of the convention. Changing



times, conditions and concepts do call for occasional reappraisals of long-held positions. And our profession now might be obliged to reappraise the corporate "taboo."

The reason for the corporate prohibition is that it was felt that a professional man should not have any legal means of evading or limiting his professional and financial obligations. However, if a corporation law were enacted that would retain the present protective aspects, this consideration would not be jeopardized. Actually, the present professional corporation laws deny the limitation of financial liability to the stockholders. Professional responsibility is still judged by the organizations existing for this purpose.

Under our present tax laws only employees may participate in tax beneficial pension and profit sharing plans—self-employed persons and partners do not qualify. Other tax relief measures are also denied the self-employed. The Jenkins-Keogh bill, which has been supported by many professions, including our own, and which would give some relief to the self-employed, has failed to pass in several sessions of Congress.

However, the tax benefits of the Jenkins-Keogh bill are now available to professions that have been permitted to incorporate under the laws of their respective states.

The Executive Committee of the American Institute of CPAs has opposed incorporation by CPAs, and the Council recently ratified their decision.

Our Society has not considered this matter. When and if we do, I am sure that our decision will be in the best interests of the public and that, if it is necessary to seek tax relief, we will do so by appropriate means.

I shall keep you advised of developments in this area and during the coming year. As matters of interest or importance arise, I shall pass them on to you.

EDWARD J. BUEHLER,  
*President*



# How to Reduce Manufacturing Inventories Quickly

By JOHN B. ROBINSON, CPA and HAROLD D. KENNEDY, JR., CPA

In a manufacturing company, the dollar investment in inventory is usually one of the largest, if not the largest, dollar amounts on the balance sheet. In addition, the evaluation of an inventory in terms of possible excess or obsolete material has a direct bearing on the net profit. Therefore, it is necessary to get behind inventory figures; to get back into the production and material control department where schedules are made, bills of material are extended, requisitions are written, and where, quantitywise, controls are established to *prevent* excess and obsolete inventory. Even though financial people evaluate excess and

obsolete inventory, the control to *prevent* excess and obsolete *quantities* in the first place lies largely in the production and material control function.

Not discussed here are long range methods for accomplishing inventory reduction and other objectives of most production and inventory control systems, such as improving customer service, reducing delivery cycles, reducing operating costs, and leveling shop loads.

This article is a composite of a number of actual situations where inventory reduction was necessary to avoid financial embarrassment and possible insolvency.

JOHN B. ROBINSON, CPA, and HAROLD D. KENNEDY, JR., CPA, are partners in Arthur Andersen & Co. Mr. Robinson specializes in the field of production control and Mr. Kennedy specializes in general auditing services. Mr. Kennedy is Chairman of the Committee on Cost Accounting and Inventory Methods of The New York State Society of Certified Public Accountants.

## XYZ CO. IN TROUBLE

The XYZ Manufacturing Company was in trouble. Although sales of its motorized truck farming and garden machinery had risen 25% in the last two years, net profits had shown a slight decrease and inventory investment had gone up 50%. The Company's financial statements for the last fiscal year are summarized as follows:

### BALANCE SHEET

#### Assets

#### Current assets:

Cash .....	\$ 10,000	
Receivables .....	500,000	
Inventories .....	2,000,000	\$2,510,000

Fixed and other assets (net) ..... 740,000

\$3,250,000

## Liabilities

### Current liabilities:

Notes payable to banks .....	\$1,000,000	
Accounts payable .....	1,000,000	
Accrued payroll, taxes, etc. ....	250,000	\$2,250,000

### Stockholders' equity:

Capital stock .....	\$ 750,000	
Retained earnings .....	250,000	1,000,000
		<u>\$3,250,000</u>

## INCOME STATEMENT

Sales .....	\$5,000,000
Cost of sales .....	4,000,000
Gross profit .....	\$1,000,000
Selling, administrative, and interest expense .....	940,000
Profit before income taxes .....	\$ 60,000
Income Taxes .....	30,000
Net profit .....	<u>\$ 30,000</u>

### BANK CREDIT CUT OFF

As indicated, the Company's cash position was precarious. It was losing \$20,000 annually in cash discounts because of inability to pay vendors' invoices on a current basis. Cash was not available to pay dividends to stockholders, who were beginning to grow restless. But, worst of all, the Company's banks would not extend their lines of credit and were exerting pressure for a reduction in the outstanding loans. The Factory Manager had assured the President six months earlier that the investment in inventory would be reduced by \$300,000 by the end of the year, and on this basis the President had informed the banks that a corresponding reduction would be made in the outstanding loans. Actually, the inventory had risen \$200,000

during the six months instead of dropping \$300,000.

### INVENTORY TURNOVER LOW

The Company was turning its inventory only twice a year, which was considerably less than competitors turned their inventories. If the inventory could be turned three times a year or once every four months, which the production cycle indicated was feasible, the inventory would drop to \$1,330,000. This decrease of \$670,000 would, in effect, generate an equal amount of cash. The inventory reduction would increase annual pretax profits by at least \$40,000 at a bare 6% cost of money. Moreover, if it is assumed that the total carrying cost of inventory (interest, obsolescence, insurance, taxes, etc.) is

20%, a total of \$130,000 annually would be added to pretax profits.

#### TARGET: REDUCE INVENTORY, INCREASE CASH

The President realized that he could probably obtain some long-term financing secured by mortgages on plant and equipment, but this step would not solve the basic problem. It was obvious that in order to correct the cash situation the Company had to make a substantial reduction in its investment in inventory as soon as possible.

The President instituted a short range program for immediate inventory reduction by concentrating on high dollar value components in open purchase commitments and in inventory. His first step was to control major purchase commitments.

#### CONTROL MAJOR PURCHASE COMMITMENTS

Before the Company's inventory could be reduced, steps had to be taken to keep it from growing larger. The objective was to shut off deliveries of the larger open purchase orders if they were not needed. The "shut off" meant either deferring deliveries

to future periods or outright cancellations.

The Company had never had a purchase commitment report. Contemplated cut-off difficulties and inaccuracies had been used as excuses in the past. The President quickly concluded that a purchase commitment report would be helpful even though it might contain some inaccuracies. He then decided that the Purchasing Department would initiate and maintain records for such a report.

An adding machine tape was run of the 1,000 open purchase orders for productive materials. Because only substantial accuracy was sought, pennies were ignored, and estimates were used in those few cases where firm prices were not available. An analysis of this tape indicated that 100 open orders of over \$5,000 each represented \$750,000, or 75% of the total. Consequently, only these 100 orders were included on the commitment report because the quickest "payoff" would come by concentrating effort on these high dollar value commitments. The first purchase commitment report as of July 31 spread the \$750,000 by delivery dates shown on vendor acknowledgments as follows:

<u>Month Due In</u>	<u>Amount</u>
Prior to July 31 (overdue) .....	\$200,000
August .....	300,000
September .....	100,000
October .....	70,000
After October .....	80,000
	<hr/>
	\$750,000
	<hr/>

#### MANY ORDERS OVERDUE

The revelation that over 25% of these major purchase orders were overdue came as a shock. Because shortages really were not excessive despite these overdue purchase or-

ders, it became apparent that too much was being asked for too soon, and that the cash position would have been even more precarious had vendors delivered requested, but unneeded, material when scheduled. Ap-

parently a defense mechanism had grown up on the part of the material ordering clerks to the effect that "if a little cushion was good, a big one was better." On the other hand, a comparison of the dates on the purchase requisitions with the requested dates on the purchase orders showed that the purchasing department was also involved in advancing requested delivery dates.

A "tip-off" on inaccurate input scheduling was obtained by comparing delinquent (overdue) purchase orders with current production short-

ages. Parts which did not appear on shortage lists but which did appear on delinquent purchase orders obviously were not needed currently. Immediately after beginning this comparison, the name of the Combustible Engine Company popped up.

#### EXCESS ENGINES ON ORDER

Engines on open order from the Combustible Engine Company totaled \$40,000 and were worth approximately \$200 each. A comparison of engines on hand and on order with the requirements for laydown in factory assembly showed:

Week Beginning	Engines on Hand and on Order		Required Per Factory Assembly Schedule(4)	
	Units	Dollars	Units	Dollars
Aug. 1	150(1)	\$30,000	8	\$ 1,600
	130(2, 3)	26,000		
8			18	3,600
15			16	3,200
22			14	2,800
29			18	3,600
Sept. 5	70(2)	14,000	20	4,000
12			16	3,200
19			18	3,600
26			14	2,800
Oct. 3			16	3,200
10			14	2,800
17			12	2,400
24			16	3,200
Totals	350	\$70,000	200	\$40,000

NOTES: (1) Engines on hand.

(2) Engines on open purchase orders.

(3) 250 engines had originally been scheduled for August 1, but 120 engines had already been received prior to August 1.

(4) Adjusted to purchase order acknowledgment schedule date by allowing a week for receipt, inspection and placing in assembly position and an additional week's safety cushion.

**Early shipment.** Review of the shipping performance of the Combustible Engine Company revealed that almost without exception shipments arrived two weeks to a month early and invoices were received usually even before the engines.

**Premature requisitions.** Furthermore, a requisition for 50 more engines was about to be placed for October 3rd delivery at the time of the review of the open order position. The President cancelled this requisition and gave immediate instructions that

in the future all requisitions for production material which exceeded \$5,000 were to be personally approved by him.

*Weekly shipments approved.* Upon analyzing the schedule comparison and talking with the Combustible Engine people, it developed that weekly shipments would be no more expensive than monthly shipments if the quantity never fell below 15 engines per shipment. A further agreement was reached with Combustible to the effect that shipments would not be made more than two days before scheduled delivery date or in excess of scheduled quantity. Upon reviewing the internal processing time for re-

ceipt, inspection, and laydown on the assembly line, it was discovered that the present period of a week was excessive and that there was no reason at all why these engines could not clear through the receiving department in half a day and through the inspection department in a day and one-half. It was finally agreed that the one week safety stock could be reduced to three days.

*Inventory cut in half.* The net effect of tightening up on the procurement and internal processing times of engines was a reduction of 60% in the inventory investment; a \$30,000 investment was cut to \$11,800.

	Working Days		Number of Engines in Inventory		
	Before	After	Before	After	Reduction
In process .....	10	10	30	30	—
In stores—					
Delivery frequency .....	20	5			
Average inventory .....	10	2½	30	8	22
Safety cushion .....	5	3	15	9	6
Premature delivery .....	10	2	30	6	24
In receiving and inspection....	5	2	15	6	9
Totals .....			120	59	61
Average investment—					
Projected .....			\$24,000	\$11,800	
Actual .....			\$30,000		

NOTE: Average usage was three engines per day. The 150 engines on hand at August 1 exceeded by 30 the 120 engines called for as a projected inventory investment per the "Before" column of the above schedule.

#### EXCESS AXLES AND TRANSMISSIONS

Some \$9,000 in excess axles and transmissions were identified by reviewing the plant-wide inventory prior to rescheduling open purchase orders. Axles were discovered in various stages of disassembly, rejection, or obsolescence, and a four-month supply of transmissions was on hand.

The President instructed:

(a) The Factory Manager to schedule work (and requisitions as required) to complete any incomplete axles and to disassemble, sandblast and paint any rejected axles.

(b) The Chief Engineer to "engineer around" obsolete axles in future specifications and to use up the excess supply even though a more expensive

axle was substituted at no price increase to the customer.

(c) The Purchasing Agent to:

- Control vendor overshipments.
- Inflate order quantities no more than 20% when reaching for price breaks (except as specifically approved by the President).

Negotiate a blanket purchase order arrangement with the vendor, and attempt to get the vendor to carry the inventory until delivery was requested.

#### CANCELLATION ATTEMPT ONLY PARTIALLY SUCCESSFUL

The Company was not too successful in its attempt to cancel \$50,000 of open orders not really needed for six months. They did succeed in cancelling about \$15,000 and deferred and rescheduled an additional \$25,000. The balance of \$10,000 was shipped by vendors within a week after cancellation was requested, thus illustrating the expediting effectiveness of attempted cancellations.

#### RESULT OF RESCHEDULING PURCHASE COMMITMENTS

After rescheduling and cancellations, instead of receiving \$670,000 by October 31 as originally scheduled, only \$400,000 was received, a reduction of \$270,000.

#### CONTROL HIGH-VALUE ITEMS

The next major step in the Company's inventory reduction program was to analyze annual dollar usage of all parts, both purchased and manu-

factured, and then concentrate close controls on the high value items.

Note that the purchase order review covered only open purchase orders over \$5,000 each. Consequently, large dollar usage purchased parts escaped attention entirely if they weren't on open order at the time of the review, and no manufactured items were covered at all. Analyzing the annual dollar usage of all parts is basic to establishing permanent control policies for all classes of parts—expensive, medium, and nominal. The Company's short-range program dealt only with control policies for the expensive parts.

A program and timetable was established for analyzing and classifying annual dollar usage. Responsibilities for specific projects were assigned to individuals, with estimated start and completion dates. Progress reports, with actual start and completion dates, were issued each two weeks.

In brief, the program consisted of steps required to compute the annual usage for all parts. Annual usage was the sum of usage for the past six months and projected usage for the next six months. The projected usage was computed by extending forecasted model production by the unit use of each component in the appropriate bills of material. Resulting parts and assemblies were then ranked in descending order of annual dollar usage.

The following data resulted from this analysis:

Class	Per Item Annual Dollar Usage*	Number of Items	Total Annual Dollar Usage	Per Cent of Total	
				Items	Dollar Usage
A	Over \$1,000	100	\$2,800,000	10%	70%
B	\$100 to \$1,000	200	800,000	20%	20%
C	Under \$100	700	400,000	70%	10%
	Totals	1,000	\$4,000,000	100%	100%

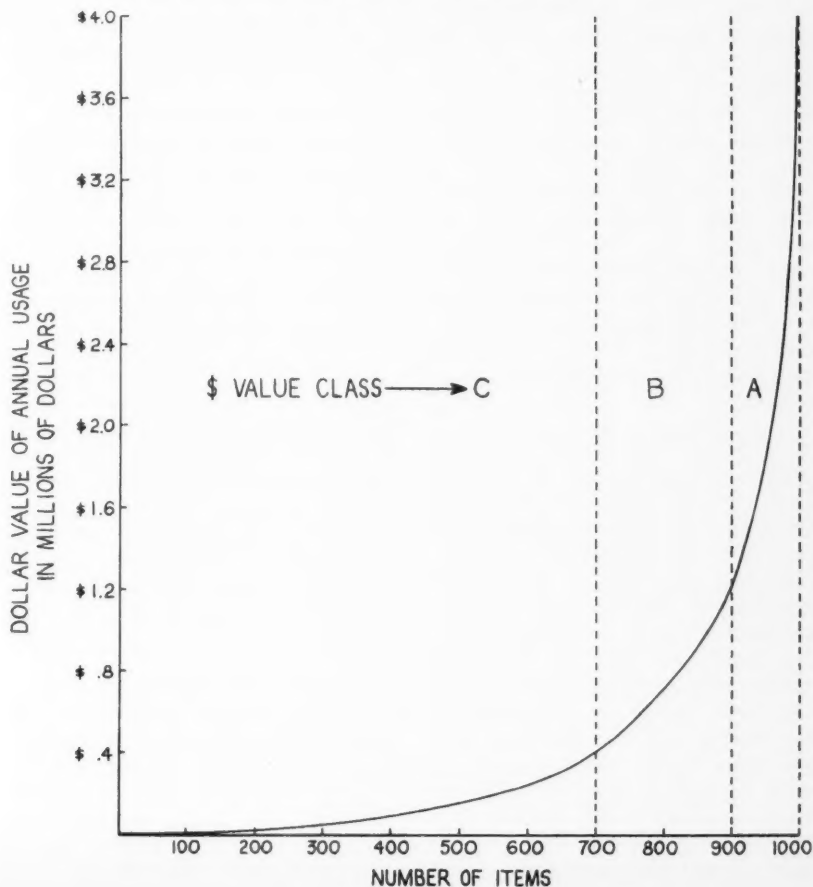
\* Similar classifications should be made in terms of unit costs and inventory values.

It should be noted that effort applied to expensive (Class A) parts results in a much greater total reduction in inventory than equal effort applied to inexpensive (Class C) parts. For example, if effort applied to the 100 parts in Class A inventory, worth \$1,400,000, resulted in a 20% decrease, the dollar reduction would be \$280,000. On the other hand, if the same effort applied to 100 of the Class

C parts (total inventory for 700 parts worth \$200,000) resulted in the same 20% decrease, the dollar reduction would be under \$6,000, ( $\$200,000 \div 7 \times 20\%$ ). The same effort would be 47 times more effective on Class A parts than on Class C parts.

The following type of graphic illustration of the annual usage data is helpful in spotlighting the dollar/quantity relationships.

THE XYZ MANUFACTURING COMPANY  
DISTRIBUTION OF ITEMS  
BY DOLLAR VALUE OF ANNUAL USAGE





#### RETURN REJECTS PROMPTLY

Special count crews noted considerable congestion in the receiving rejects area. The Factory Manager then arranged to have a complete physical inventory taken of the receiving rejects area. This inventory disclosed that over one-third of the items had been in the receiving rejects area over a month. Analysis of a few of the more expensive and older items indicated that rejects were not returned promptly to vendors when they were unquestionably defective, but instead (after a "bottom of the pile" two-week delay) letters were directed to vendors requesting permission to return or to rework at vendor expense. After reviewing this situation, the President authorized the immediate return to vendors, without their prior permission, of all receipts defective beyond question. He recognized that initially some vendors would object to this return policy but that this reaction could be surmounted satisfactorily if care was taken not to abuse the policy by returning material where the Company's purchase orders, drawings, specifications, or test equipment were at fault.

#### "STARVE" WORK IN PROCESS AREAS

While walking through the machine shop after the day shift had gone home, the Factory Manager began to count the jobs in front of each machine. He was amazed to find that material for some jobs had been sitting for two to four weeks while material issued only that day for lesser priority jobs was already being worked on. He expanded his test checks to the drilling and milling departments and found that the same situation existed. From these observations he was forced to conclude that workers were "picking" the jobs they were going to work on and were continually avoid-

ing and delaying other jobs. Therefore, he immediately instructed his shop dispatching people to start "squeezing down" on the number of jobs being started so that there would be less opportunity for workers to ignore disagreeable or tightly-rated low-bonus jobs. After three months, the net effect of tightening up on the number of orders and amount of material in the shop (sometimes referred to as "planned scarcity") was a reduction of over a third in the work in process inventory. In addition, shortages actually decreased because unattractive jobs were no longer buried on the factory floor, and the housekeeping improved tremendously because of less material on the floor.

#### ACCOUNTING TREATMENT

Because such a small number of expensive items constituted the bulk of the dollars invested in the Company's inventory, simplified control was achieved by segregating all Class A receipts and usage in a separate inventory account. The mechanics behind this segregation consisted of identifying all Class "A" parts on bills of material, inventory records, purchase requisitions, and purchase orders. Subsequent identification on receiving tickets and vendors' invoices was routine. Inventory was relieved by the cost of the Class "A" components in shipments. Knowing the investment in expensive components provided management with prompt information on major progress in inventory reduction.

#### NET REDUCTION EFFECTED

In three months the inventory was reduced \$500,000 and customer service was maintained. Management was confident that four turns a year were possible and that an additional \$500,000 could be eliminated through continued application of the short



range practices illustrated above and through a long range inventory control program (not described here) which would encompass forecasting, parts standardization, part numbering revision, and economic order quantity computations under strict obsolescence limits.

#### SUMMARY

By concentrating first on high dollar purchase commitments and then

on all high dollar annual usage items, maximum reductions were made quickly. Specific inventory reduction steps included increasing delivery frequency, refusing premature shipments, reducing cushions for internal processing times, reducing safety stocks, controlling "reaching" for price breaks, placing blanket orders, attempting to get vendors to carry inventory on a consignment basis, and "starving" the factory to shrink swollen work in process inventory.

THE END

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### BUSINESS OBLIGATIONS

I say that people often ask, Can I be ethical and be in business? But not infrequently, in my experience, individuals are not really asking this question at all, they are only apparently asking it. What they are seeking is justification for themselves from someone else, particularly from a spiritual leader, that whatever they find themselves obliged to do in order to stay in business is all right. There are the facts of business life with which one must live if he is to be in business. One also has to live with himself. And we know that for a person of sensitive conscience, one having high standards of behavior for himself in his relationship with others, the personal problems of behaving ethically in business are sometimes most momentous. There are countless individuals who are obliged to do things in business which are a perpetual offense to them.

Important as are these individual, personal problems, however, it seems to me that we as citizens must give increasingly greater attention to the ethical problems of the relationship of business and the community at large. We must concentrate more on the social problems which business involves, since the corporate life of our time enfolds us all, whether we are or are not in business. The relationship of business with the larger community has much more to do with the ethical life of our time than all the moral talk from all the pulpits in the United States. For business practices and attitudes largely determine how all of us live.

JEROME NATHANSON, Business Practices and Business Ethics, THE ETHICAL PLATFORM, March 27, 1960

# Standards of Reliability for Audit Evidence

By FLOYD W. WINDAL, Ph.D., CPA

Certain auditing concepts have become axioms. Yet, because of their ephemeral nature, they are often dealt with more by intuition than by measurement. Prominent in this category are rules on consistency, materiality and the reliability of audit evidence. In this article the author sets up guide lines for the practitioner's appraisal of the various types of audit evidence that he deals with in his daily work.

The relative reliability of the various types of audit evidence is a very nebulous subject, but one which deserves a great deal more attention than it has received in the past. If an auditor is not consciously aware of the very distinct differences in reliability of the various types of evidence, he may well draw unwarranted conclusions from evidence obtained, and do either too little or too much work in a given area. It is quite probable that, in a good many cases, the auditor gives little or no consideration to *relative reliability*, and relies to a large extent upon what was done last year in deciding what to do this year. This approach, of course, can be dangerous. Serious thought should be given *each* year to the preparation of an audit program, with particular attention being paid to the relative reliability of the various types of audit evidence to be obtained. Re-

vision of this program in the light of things discovered in the process of the audit is, of course, also essential.

Evidence has been defined as any document, procedure, or piece of information which assists the auditor in forming his professional opinion as to the accuracy of the financial information he examines.<sup>1</sup> This evidence is obtained through the application of one or more audit techniques. The following techniques are listed by one author.<sup>2</sup>

Physical examination and/or count.  
Confirmation.<sup>3</sup>

Examination of original documents  
and comparison with the record.  
Recomputation.

Retracing bookkeeping procedures.  
Correlation with related information.

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<sup>1</sup>R. K. Mautz, *Fundamentals of Auditing* (New York: John Wiley and Sons, Inc., 1954), p. 33.

<sup>2</sup>*Ibid.*, p. 49.

<sup>3</sup>*Confirmation*, as used here, refers to the acquisition of written evidence from an independent, outside source.

Examination of subsidiary records.  
Scanning.  
Inquiry.<sup>4</sup>

Each audit procedure performed embodies one or more of these techniques. It follows then, that if the auditor has some awareness of the relative reliability of the evidence obtained through the use of the various techniques, he can better judge the adequacy of his audit procedures. Certain standards of reliability, dealing with such things as independence, objectivity, auditor qualification, and internal control, can aid him in this judgment process. Each audit technique can be examined to see how it measures up to the standards. A rating system may even be devised for expressing the results of this examination. In the following sections, some general and special standards of reliability will be presented and applied to each of the audit techniques. Each technique will then be rated on the degree to which it meets the general standards.

#### STANDARDS OF RELIABILITY

Those standards of reliability which are general in nature and can be applied to all of the audit techniques are:

1. Evidence which is obtained from a source independent of the enterprise being audited tends to be more reliable than evidence obtained from a source within that enterprise.
2. Evidence which is objective in nature tends to be more reliable than evidence which reflects personal judgment or bias.

<sup>4</sup>*Inquiry*, as used here, refers to the oral questioning of officers and employees of the enterprise being audited, and of outside parties. The answers of the officers and employees may be oral or in writing, whereas the answers of outsiders must be oral. Written answers obtained from outsiders would be classed as confirmations.

3. Evidence obtained by the auditor himself or by his representative tends to be more reliable than evidence supplied by another, except where the auditor is not qualified to obtain that evidence.

The remaining standards might be termed special in that they are limited in scope. They can be applied to only a few of the techniques.

1. Evidence based upon internal data which have been derived from an accounting system containing adequate internal control tends to be more reliable than evidence based upon data derived from a system without such control.

2. Evidence obtained from outside sources which maintain formal accounting records and/or have a sense of public or personal responsibility tends to be more reliable than evidence obtained from an outside source with inadequate records and/or little or no sense of public or personal responsibility.

3. The examination of items which are relatively more susceptible to fraud tends to give less reliable evidence than the examination of items less susceptible to fraud.

4. In those special situations where the auditor is not qualified to apply a particular technique, the evidence obtained from such application is relatively unreliable.

5. Confirmations which can be handled without effort by the party confirming tend to be less reliable than confirmations which require effort.

#### APPLICATION OF THE STANDARDS

It is not expected that application of these standards will provide the final answer as to the relative reliability of the evidence provided by the techniques. First, the techniques themselves are too varied in their

nature and purpose to be ranked in any absolute order. Second, the standards are of varied importance, and it would be a difficult task to assign the proper weight to each. However, application of the standards provides a great deal of information about the overall reliability of each technique. It points up the strengths and weaknesses of each. The audit techniques will now be examined in the light of the standards.

#### PHYSICAL EXAMINATION AND/OR COUNT

Items physically examined by an auditor are, in a sense, independent in themselves. Subject to the possibility that a particular item is not owned by the enterprise in question, its very possession by that enterprise is significant. This is true even though many such items are involved, and though other enterprises possess similar items. Each such item has an individuality of its own, and is in itself, an outside source of information.

The examination of specific items by the auditor is objective in nature. A particular item is either physically present or not. Personal judgment or bias does not enter in on this point. An important characteristic of this technique is that the auditor does the work himself. He, personally, verifies the physical presence of the items in question and therefore relies upon no one else.

All of these conclusions must be qualified when considered in connection with special standards Nos. 3 and 4. The very use of the technique of physical examination implies that the auditor is able to recognize the item in question. He must be able to relate it to a specific account, know that it is genuine, know that he has not counted it twice, and be reasonably sure of its quality. If, as suggested in

special standard No. 4, he is not qualified to examine the item in question, the reliability of such an examination must be questioned. For instance, the physical examination of cash would be more reliable than the physical examination of some rare jewels. It is obvious that an auditor is not expected to be an expert in rare jewels, and it would probably not be difficult to convince him that some cut glass objects were jewels. Contrast this with his examination of currency or coin. Except in the case of very large bills, he is perfectly qualified to determine whether the paper and metal objects he is examining are actually money.

Closely akin to the auditor qualification situation is that suggested by special standard No. 3. Certain items which the auditor examines are more susceptible to fraud than others. There is a much stronger possibility of the presence of fraud in connection with the examination of such items as notes receivable than in connection with cash. The notes, for instance, might be pledged as collateral for a debt, with no notation being made on the note. Or, the notes themselves may be false—not even a bona fide asset. Cash, on the other hand, is not susceptible to that sort of thing. Cash on hand certainly cannot be pledged as collateral, and the chance that it is counterfeit is very slim.

#### CONFIRMATION

By its very nature, this technique provides evidence independent of the firm being audited. Confirmations, mailed by the auditor to outside parties and returned by them directly to him, are free from internal handling and influence. The only qualification that might be noted here is the possibility of collusion between the outside party and the enterprise being audited.

The answers provided by outsiders in reply to requests of the auditor are, by their very nature, objective. A debtor either agrees or disagrees with the amount shown to be receivable from him; the balance of cash on hand in the bank is definitely stated; and a certain amount of inventory is either on hand in a public warehouse or not. Some degree of reliability is lost in that the evidence provided by this technique is not obtained by the auditor himself. He must rely upon others, and the possibility of false or unreliable reports thus arises. The person confirming may not exercise even reasonable care in acquiring the information desired.

As indicated in special standard No. 5, the type of confirmation used will cause a variance in the reliability of this technique. Positive confirmations, which are to be returned whether or not the information contained thereon is correct, are more reliable than negative ones, which are to be returned only if the information is incorrect. Blind requests, where the party confirming must write in the information desired, are the most reliable.

Special standard No. 2 is also of significance here. For instance, bank confirmations are more reliable than some accounts receivable confirmations. An institution such as a bank undoubtedly has a formal set of accounting records, whereas private individuals probably have few, if any, records. Logically, the bank is in a much better position to confirm its liability to a specific enterprise than is the private individual. Furthermore, the bank holds itself out to the public as an institution to be trusted and held in high regard. To give false information or to refuse to confirm specific balances would serve to tear down this respect, which is essential to its well-being. Some private individuals, on the other hand, have no sense of respon-

sibility. They may care little what is thought of them, and feel no obligation to return a confirmation request, or to answer it correctly if they do return it.

#### EXAMINATION OF ORIGINAL DOCUMENTS AND COMPARISON WITH THE RECORD

This technique might be classed as resulting in partially independent evidence. Some documents originate with an independent source, and others do not. Purchase invoices, for instance, originate outside the enterprise, while purchase requisitions do not. Those originating with the independent source have at least a degree of independence about them, even though they are under the control of the enterprise being audited. The fact that they have come under the control of the enterprise, of course, prevents them from being considered entirely independent.

The examination of original documents and their comparison with the record is essentially an objective procedure. Either there *is* a supporting document or there is *not*, and it either *can* be traced to the accounting records or it *cannot* be. Personal judgment might be said to enter in when determining whether or not a particular document is a genuine one, thus detracting somewhat from the objectivity of the technique. As in the case of physical examination, the auditor does the work when this technique is applied. He need not worry about the mistakes, incompetence, or lack of desire of outsiders.

Special standard No. 3 can also be applied to this technique. Those documents which are relatively easy to reproduce are more likely to be fraudulent than those documents which are difficult to reproduce. The examination of the former would thus tend to give

less reliable evidence than the examination of the latter.

A final standard that can be applied to this technique is special standard No. 4, relating to the qualification of the auditor. For example, the examination of a contract written in highly technical legal terms is less reliable than the examination of a cancelled check. The examination by the auditor of the contract, which he may not be able to interpret correctly, would probably not result in very reliable evidence concerning its contents.

#### RECOMPUTATION

This technique might also be classed as partially independent. In some cases the computations made by the auditor are partially based on data obtained from an outside source. For example, computation of the value of securities is based upon publicly quoted market prices. Computation of accrued interest income on bonds is another example. Here, the applicable interest rates are obtained from an independent investment service, or from the bonds themselves. Footing a book of original entry is an example of a computation in which no independent outside source is involved.

This technique is, without question, objective. What can be more objective than adding a column of figures, or extending an inventory sheet. In such procedures there is no room for personal judgment or bias. The evidence obtained from the application of this technique is first-hand in that the auditor or his representative do the work themselves.

#### RETRACING BOOKKEEPING PROCEDURES

The data involved in the application of this technique are entirely internal, thereby rendering the resulting evidence entirely void of independence.

The various books of original entry, the general and the subsidiary ledgers, are all illustrations of such internal data.

The work is objective in nature, in that the auditor is retracing definite bookkeeping procedures that have been performed. As a result of his examination, he will find that such procedures either have or have not been performed accurately. A specific item was either posted correctly or not. This technique is, of course, applied by the auditor himself.

In connection with special standard No. 1, the reliability of this technique will be related to the degree of internal control present in the enterprise audited. Greater reliance can be placed on the evidence obtained if good internal control is present.

#### CORRELATION WITH RELATED INFORMATION

This technique might be classed as partially independent. In some cases, internal data are correlated with data originating at an independent source. For example, dividends received may be correlated with dividends paid, as reported by an independent investment service. In other cases, the correlation deals solely with internal data. The amount charged to a particular expense in the current year may be compared with the amount charged in previous years. In this latter type of comparison, there is no independence at all in the evidence obtained.

Frequently, the application of this technique cannot be entirely objective. The auditor's judgment is often called upon in determining whether or not to attach significance to a particular correlation. In contrast, there are some situations in which the technique can be applied objectively. In comparing the balance of the Insurance Expense



account with the decrease in the Prepaid Insurance account over the year, for example, no personal judgment need enter in. The two figures either agree or they do not. If the auditor were correlating the insurance expense between this year and last, however, personal judgment certainly would be of importance. The significance of any variation or lack of variation would have to be determined, making the evidence more subjective than objective. This work is, of course, first-hand, as it is done by the auditor himself.

#### EXAMINATION OF SUBSIDIARY RECORDS

Subsidiary records are not, of course, independent from the enterprise being audited. They are a part of that enterprise's set of accounting records, and as such, are subject to its control. The examination of these records by the auditor is basically objective. They are either complete and in agreement with a control account or they are not. The auditor's judgment perhaps enters in to determine whether or not the records are genuine. This technique is first-hand in that the auditor performs the examination himself.

Again of consideration here is special standard No. 1. A good system of internal control in connection with the subsidiary records would make this technique more reliable.

#### SCANNING

This technique normally does not provide evidence from a source independent of the firm being audited. In certain cases, however, the data scanned may have originated with an outside source, thus lending to it some degree of independence. An example of this might be a union contract. In other cases, however, as with general journal entries, no independence whatsoever is found.

The evidence provided by this technique is very subjective. The whole basis of the technique, in fact, is the auditor's judgment. Probably no other technique is quite as subjective as this one. The evidence obtained is first-hand, however, as the auditor performs the work himself.

Of importance here is special standard No. 4. The auditor must be qualified to do the scanning if evidence of any reliability is to be obtained. He must be able to recognize, readily, unusual or incorrect items contained in a body of accounting or financial data. Scanning performed by an inexperienced junior would, of course, give relatively unreliable evidence. In most cases, he does not have the necessary background and experience to be truly qualified to use this technique.

#### INQUIRY

Evidence obtained from the utilization of this technique is not usually independent in nature. Inquiries are directed primarily at employees or officers of the enterprise being audited, and would certainly not be independent. In some cases, however, inquiries may be directed to outsiders, and would thus be independent from the enterprise being audited. An example of this would be a phone call to an enterprise debtor to verify an account receivable. Such an inquiry might be made where no reply was received to a written confirmation request.

Complete objectivity is also lacking in this technique in that the auditor must evaluate most answers received. It is true that some questions, by their nature, result in answers which are objective, and which need little or no interpretation. Questions as to the location of documents or as to specific procedures followed are examples of this type. Other questions and answers border on the other extreme and are

of such a nature as to require interpretation. An example of this type would be a question as to the condition of inventory. The evidence provided by this technique is second-hand in nature. The auditor asks the questions and the answers are provided by another.

## SUMMARY AND CONCLUSIONS

The following table shows how each of the audit techniques discussed measure up to the general standards. It helps summarize the preceding discussion, and illustrates one way in which this type of analysis may be expressed.

## APPLICATION OF GENERAL STANDARDS

	General Standard No. 1 Independent	General Standard No. 2 Objective	General Standard No. 3 First-Hand
Physical examination and/or count .....	A	A	A
Confirmation .....	A	A	C
Examination of original documents and comparison with the record .....	B	A	A
Recomputation .....	B	A	A
Retracing bookkeeping procedures .....	C	A	A
Correlation with related information .....	B	B	A
Examination of subsidiary records .....	C	B	A
Scanning .....	C	C	A
Inquiry .....	C	B	C

Legend: A—Independent, objective, or first-hand  
 B—partly independent, objective, or first-hand  
 C—not independent, objective, or first-hand

A table such as this should be viewed as a starting point rather than as an end to any analysis of reliability. It should be remembered that the standards used are not necessarily of equal importance, and that the letter rankings indicate only generally how the techniques measure up to the various standards. Averaging the letter rankings will not necessarily give valid results as to the relative reliability of the various types of evidence. Furthermore, this chart does not take into consideration any of the special standards discussed earlier.

It should further be remembered that a particular technique is not useless to the auditor merely because it

is not very reliable in itself. When used in conjunction with other techniques, some very reliable evidence may be provided. The areas of weakness and strength in two techniques may offset one another, and a very reliable audit procedure may result. Furthermore, the application of a relatively unreliable technique may be very valuable in pointing up areas that need further investigation.

The standards presented here are not necessarily exhaustive. Others perhaps can be devised and applied to the various techniques. It is hoped that those presented are sufficient to stimulate further thought in this direction.

THE END



# Materiality

By STEPHEN CHAN, CPA

This article brings into focus the guides that should be utilized in determining what, or how much, is material, a common problem for practitioners. It may be that inadequacies in this respect are responsible for some of the sub-standard reporting which our profession is determined to eliminate. The guides herein summarized should be helpful in crystallizing judgments. The discussion should lead to more definitive, formal conclusions by our profession.

**A**ccountants are frequently exposed to situations involving use of the terms "material" or "materiality." The general implications of these terms are easily grasped. However, their application to specific situations is not a simple matter. Good judgment, sound analysis and experience are factors that enter into a determination, but these intangible qualities cannot readily be translated into a set of rules. Nevertheless it does appear possible to develop guidelines to aid accountants in reaching a decision as to whether a specific item or transaction is material.

Although this subject has received attention in accounting publications (see bibliography at the conclusion of this paper), it is the purpose of this dissertation to further explore the meaning of the terms "material" and "materiality."

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## DEFINITION

Webster's Dictionary defines the adjective "material" as:

"of solid or weighty character; substantial; of consequence; not to be dispensed with; important; essential; pertinent; relevant."

The word "materiality" is defined as:

"importance in some given respect; substantiality; as, the materiality of facts."

## USAGE

The Rules of Professional Conduct of The New York State CPA Society and those of the American Institute of CPAs (Rule 5 in each case) mention (a) "material fact," (b) "material misstatement," (c) "materially negligent," (d) "exceptions sufficiently material," (e) "material departure" and "material omission."

In 1954, the American Institute of CPAs published a special report by its Committee on Auditing Procedure, titled "Generally Accepted Auditing Standards." The section dealing with standards of field work refers to "materiality" in the following terms:

"There should be stronger grounds to sustain the auditor's opinion in respect of those items which are relatively more important and in respect of those in which the possibilities of material error are greater. For example, in an enterprise with relatively few, but large, accounts receivable, the individual items themselves are more important, and the possibility of major error is also greater, than in another enterprise which has a vast number of small accounts aggregating the same total . . . the principle of materiality is inherent in the work of the auditor."

Accounting Research Bulletin No. 43 published in 1953, states on page 9:

"The Committee contemplates that its opinions will have application only to items material and significant in the relative circumstances. It considers that items of little or no consequence may be dealt with as expediency may suggest. However, freedom to deal expeditiously with immaterial items should not extend to a group of items whose cumulative effect in any one financial statement may be material and significant."

Rule 3.02 of the Securities and Exchange Commission's Regulations S-X states:

"If the amount which would otherwise be required to be shown with respect to any item is not material, it need not be separately set forth . . ."

Rule 2.02 states, in paragraph (c):

"The accountant's certificate shall state . . . the opinion of the accountant as to any material changes in accounting principles or practices . . ."

The matter of materiality also has frequent application in determining the need for, and extent of, the audit procedures to be used in connection with specific items or transactions.

#### STANDARDS OF MATERIALITY

It is dangerous to excuse deviations from proper practice by reasoning that the amount involved is not material. A combination of non-material items may result in present or future material differences.

For instance, if a depreciation rate or method is changed in November of a calendar year, there may be no material effect on the current year's operations. However, the comparability between the next year and the current year will be affected.

If \$10,000 of income is not accrued at December 31 of a year in which a \$120,000 profit was earned, there is no material effect. However, if in the next year, operations would show a \$9,000 loss except for the \$10,000 of prior income now included, there may be a material difference to a credit grantor.

Some accountants may have used the rule of "expediency" or "relative risk" as a substitute for a standard of "materiality." In this connection, it should be recognized that the client's accounting methods and financial statement disclosures are often in conflict with the tax laws of the U. S. Treasury, with creditors' desire for detailed information, or with union negotiators' requests for cost or profit data. The bookkeeping treatment of an item of income or expense, and its reflection on the client's financial statements must run the gauntlet of conflicting desires, as a result, the CPA often becomes an umpire or arbitrator and cannot always arrive at the theoretically correct decision. His compromises are often based on the effect or materiality of the item in dispute and not on what the layman or student would consider to be accounting exactitude.

Materiality has two criteria, namely:

1. The *relative largeness* of the amount.

2. The importance of the information to interested third parties, regardless of the amount; in other words, the *nature* of the item and its effect on the conclusions which may be drawn from the financial statement.

The largeness of an amount must be considered in relation to another amount. For example, a liability may be related to total liabilities or to total capital; an asset may be related to total assets or to total capital; an expense may be related to sales, operating profit or net profit.

The *nature* or importance of an item becomes a factor in cases involving disclosure of sensitive items, however small, such as loans to officers, factoring of customers' accounts, non-recurring or unusual income or expense items, and others.

The questions "to whom may this item be material?" and "to whom may lack of this knowledge be important?" should be answered before a decision is made as to the materiality of any item. To illustrate, a corporation may pledge its receivables or may discount notes receivable; it would be important to a banker or credit grantor to know of this practice, even if the amount involved at the balance sheet date is not material.

Mr. M. N. Chetkovich (Journal of Accountancy, December 1955) stated:

"Our philosophy with respect to materiality is much more important than any specific measurements we may use. The concept of materiality should not be used as a refuge for escaping unpleasant issues but rather as a means for separating the important from the unimportant. If an item because of its nature warrants disclosure in principle, materiality should be a consideration only from the point of avoiding disclosures which are so triv-

ial as to be meaningless or to obscure the important data . . . Not only the amount but the nature of the item must be considered. For example, we would apply a much narrower measure of materiality to transactions between a corporation and its management than to such matters as purchase commitments or long-term leases."

#### S.E.C. GUIDES TO MATERIALITY

*Regulation SX Rule 1.02.* "The term 'material,' when used to qualify a requirement for furnishing information . . . limits the information required to those matters as to which an average prudent investor ought reasonably to be informed . . ."

"The term 'significant subsidiary' means a subsidiary . . . the assets of the subsidiary, or the investments in and advances to the subsidiary by its parent . . . exceed 15% of the assets of the parent and its subsidiaries on a consolidated basis . . . or the sale and operating revenues of the subsidiary exceed 15% of the sales and operating revenues of its parent and the parent's subsidiaries on a consolidated basis."

*Rule 5.04.* This rule provides, among other things, that schedules (investments in securities of affiliates and property, plant and equipment) may be omitted if the total amount of either item does not exceed 5% of total assets.

The SEC's Accounting Series Release No. 41, however, also states that the significance of an item may be independent of the amount involved, as in these instances:

"For example, amounts due to and from officers and directors, because of their special nature and origin, ought generally to be set forth separately *even though the dollar amounts involved are relatively small*. Likewise, disclosure of the various types of surplus, the important reserve accounts, and, the accrued liability for taxes is

of importance. In the same way, in the corporate income statements of a company having large investments in subsidiaries or in the securities of unaffiliated companies, the disclosure of income from dividends and interest is necessary *irrespective of the amount*, since the absence or smallness of dividend and interest income is of as great importance as the exact amount thereof."

#### MATERIALITY IN PRACTICE

The question of materiality of an item deserves special attention in the following circumstances:

- a) Where there has been a departure from generally accepted accounting principles,
- b) Where there is a question of whether or not to disclose certain information,
- c) Where there is a question of how to classify an item on the financial statements.

Several illustrations of "materiality" in financial statement disclosures, more on grounds of principle than of relative amount, are submitted for consideration. At first glance these items may not seem material, but consideration of third party interests gives them a status of materiality.

In each case let us assume a client whose financial statements reflect stockholders' equity of \$500,000 at December 31; sales of \$2,000,000 for the year; and a net profit of approximately \$100,000 for the year under review. There are no outside stockholders; and the business is owned by two brothers who are actively engaged therein. A bank credit line of \$300,000 is used at times during the year.

(1)(Q) The client writes off unexpired insurance premiums as they are paid. The major policies are written for three year periods and the premi-

ums are paid in full at the inception of coverage. Premium payments range from \$10,000 to \$20,000 per year. Is this material?

(A) There is no material effect on the balance sheet but there may be an effect on any year's profit and loss statement. This practice is a material departure from generally accepted accounting principles and requires a report comment and statement footnote.

(2)(Q) During the current year, the client purchases equipment at a cost of \$30,000, which has an average depreciable life of six years. The company charged the full purchase price to "expense" this year. Is this material?

(A) This is not material in relation to the balance sheet, but is material in relation to the year's net profit. It is also a departure from generally accepted accounting principles and requires a report comment and statement footnote.

(3)(Q) The client sells machine parts; during the current year a commission of \$30,000 is earned on a referral of some business to an exporter. The client does not want to reflect the commission as "other income" or as a separate item on the income statement, but includes it in "sales." Is this sufficiently material to be segregated on the income statement? If it is not segregated, should the first operating statement caption read "sales and other income?"

(A) This is not material, but, in my opinion, if the commission item is unusual and non-recurring, and is *not* segregated, the first caption, or sales caption, should indicate that it includes other income.

The matter of materiality is also of importance in determining the extent of audit procedures. For instance (using the assumed client described above):

(a) The accounts receivable comprise 600 debtors, aggregating \$400,000; the balances range from \$30,000 down to \$150. Ten debtors owing a total of \$40,000 are located in South America. The client does not want confirmations mailed to the South American debtors; should the CPA mention this in his report?

(b) The inventory total is \$500,000; approximately \$400,000 is located at the main premises and \$100,000 is located equally at four warehouses in other sections of the United States. In the interests of holding the fee in line, the client does not wish the CPA to attend inventory counts at the outside warehouses. Should the CPA disclose this in his report?

In both cases the amount itself is not material, but a *whole class of items* are not independently verified; the auditor should mention this in his scope paragraph, but if he can satisfy himself by other means, he need not qualify his opinion paragraph.

#### OTHER GUIDES FOR JUDGING MATERIALITY

The most exhaustive published guides to the determination of materiality resulted from a survey for a Ph.D. thesis made by Sam M. Woolsey; tabulations and conclusions therefrom were published in the February and December 1954 issues of *The Journal of Accountancy*.

In order to determine what a representative group of large and small CPA firms, controllers, bankers and professors of accounting would consider "material" in several situations, Mr. Woolsey circulated a questionnaire. The replies are useful in disclosing an area of basic opinion where relative size alone is involved. But they also demonstrate a need for a definitive determination of where the profession draws the line between "mate-

rial" and "non-material" where only relative size is involved.

For instance, Mr. Woolsey's questionnaire dealt with a manufacturing company which sold two buildings during the fiscal year, at a profit; the sale was made because the company was transferring a portion of its manufacturing to a more favorable location. The question raised was whether the realty sale profit was sufficiently "material" to be excluded from the figure called "net income" for the year, and classified as extraordinary income or as a credit to retained earnings.

The replies of 80% of the respondents held that relationship to the current year's income was the criterion; the average of the National CPA firms' responses indicated that a profit in excess of 15% of current income was material; local CPA firms considered such a profit in excess of 11% of income to be material; bankers reported 8%, professors 11%, and controllers 6%, as the dividing line. However, approximately 20% of the respondents stated that they would rely on the *amount* of profit, or on factors other than relation to income, in determining whether the gain was material.

Mr. Woolsey also asked the group to state what criteria they would use, under circumstances illustrated by him, to determine whether each of three items was sufficiently material to require disclosure on a balance sheet: (1) rent under long-term leases, (2) a decline in market value of marketable securities, and (3) a contingent liability on a patent infringement suit.

(1) Most respondents decided lease rental materiality by relating it to the corporation's average annual income; about one-third considered the *length* of the lease to be the deciding factor.

Of those who would determine materiality of lease rentals in relation to annual income, the National CPA

firms considered an amount of 17.6% of income to be the dividing line, the local CPAs 12.3%, and investment bankers and professors of accounting 9.3%.

(2) In the case of a decline in the value of marketable securities, the respondents were closer in their opinions of what amount of decline in relation to current income required financial statement recognition of the loss. The National CPA firms used an average of 7.5% of income as the dividing line, the local CPAs 5.4%, and the controllers 4.3%.

However, about 30% of those replying would use the ratio of the decline to the cost of the securities, in deciding what was a material amount. The average dividing line this group was 6.2% of the cost of the securities.

(3) In deciding the need for disclosing a contingent liability on a lawsuit in a balance sheet footnote, 30% of those responding gave primary consideration to the relationship of the amount of the contingent liability to working capital. The National CPAs (apparently with large corporations in mind) indicated (as an average) 6.1% of working capital as the dividing line, while the average of local CPAs was 1.5%, and of the bankers 4.2%.

However, another 30% of those responding considered the dollar amount of contingent liability (not its relation to working capital) to be the most important factor.

Mr. Woolsey's conclusion is pertinent; he stated:

"Although theoretically two qualified accountants should reach the same decision as to the materiality of a given item, in practice opinions are sometimes exactly opposite . . . One reason for this difference is the lack of a standard way for judging materiality. Although it would not be reasonable

to expect that materiality decisions could be made on a 100% objective basis, it does seem that the profession could establish some mathematical guides to aid the accountant's primary decision."

#### CONCLUSION

In my opinion, the situation is not helped by the past practice of the American Institute's Committees of avoiding specific rules which, at their inception, may make client-accountant relations more difficult. Consider this quotation from Accounting Research Bulletin No. 43 (pages 59 and 60):

"It must also be recognized that the ultimate distinction between operating income and charges and non-operating gains and losses . . . has not been established." . . . "In the Committee's view, the above facts . . . make it *incumbent upon readers* of financial statements to exercise great care at all times in drawing conclusions from them." (Italics added).

This quotation seems to say that we are unable to establish specific criteria, therefore it is "incumbent on readers to exercise great care." This attitude must be corrected if the profession hopes to reach and hold the public status and regard to which it believes itself entitled. Perhaps the new Accounting Principles Board of the American Institute of CPAs will establish more specific mathematical and principle borders beyond which "judgment" must not take the place of rules, in every area where this is feasible.

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## THE VALUE OF INTERIM STATEMENTS

It is now generally accepted that interim financial statements are valuable to shareholders, to prospective shareholders and to companies. They are valuable for at least three reasons. In the first place, shareholders should have complete confidence in the companies in which they invest. Such confidence can only be built on fair information rendered sufficiently frequently to maintain continuity. Secondly, prospective shareholders should have a proper opportunity of valuing the worth of shares in which they propose to invest. The lack of current information is obviously a substantial handicap. Thirdly, the fiduciary relationship of directors to their shareholders is made more difficult by the possession of important and confidential information for long periods of time. It is, of course, the responsibility of directorship to accept the burden of such confidential information. Frequently this information must confront directors with the difficult decision as to whether or not it may be used for their own gain. When shares are sold to or purchased from existing shareholders by a director, the question may arise as to whether the director has, in fact, taken advantage of information necessary to his office with a consequent loss to the individual shareholder. It must not be assumed that this does occur in all transactions between a director and another shareholder. This responsibility is greatly lightened by the frequent publication of financial information.

EDITORIAL, THE CANADIAN CHARTERED

ACCOUNTANT, November 1960



# Official Release

## STATEMENT ON COMPETITIVE BIDDING FOR AUDIT SERVICES

ED. NOTE: *The following statement has been issued jointly by the general committee on accounting of the Municipal Finance Officers Association of the United States and Canada and the committee on local governmental accounting of the American Institute of Certified Public Accountants. It is a revision of a joint statement issued in 1955. It is being distributed by MFOA to associations of government officials and is being made available by the Institute to state CPA societies for local distribution.*

**C**ompetitive bidding can be an effective tool in government when properly used.

It enables a governmental agency to obtain commodities of the highest possible quality at the lowest possible price.

This is a useful method only if the items purchased can be measured by exact specifications. A request for bids on a commodity or item of equipment, for example, can specify quality, grade and other recognized specifications for which acceptable standards have been formulated—and the delivered commodity or equipment can be tested to ensure compliance with these standards. Units of measurement and performance for construction projects can also be determined and specified.

Competitive bidding, however, is not an effective procedure in arranging for an independent audit.

It is not effective for the simple reason that an audit is not something

which can be covered by rigid specifications. An audit is a professional service requiring professional independence, skill and judgment. An independent auditor should have as much latitude as he may find necessary to be assured that the records are in order and that the system of accounts is functioning properly.

Yet many governmental agencies continue to call for competitive bids in obtaining the services of independent certified public accountants.

This confusion of principle, incidentally, is confined almost exclusively to independent auditing services. It is not common practice for government officials to advertise for bids in order to engage appraisers in condemnation actions, lawyers to represent them in court, or architects or engineers to prepare plans and supervise construction of a building or a highway.

It may be that public officials continue to use competitive bidding in the belief that it is legally required with respect to professional services. If this impression exists, legal opinion should be sought in order to settle the question.

If selected by a process of competitive bidding, the independent auditor will approach his work with an awareness that he has somewhat demeaned his profession in accepting an engagement on a bid basis. Moreover, he will generally be hampered by either overly detailed or inadequate specifications which he had no part in framing and therefore may be required to perform

work which, in his professional judgment, need not be done, or precluded from doing work which he knows ought to be done.

Independent auditors should not be subject to arbitrary dictation in matters pertaining to their work, and auditing should not be placed on the lowest possible standard of performance which can be made acceptable.

This statement is not intended to challenge the right of governmental officials to obtain some estimate of their auditing expenses. Once a governmental agency has decided to engage an independent auditor, it ought to discuss the engagement with the auditor it believes to be the best qualified to render the most satisfactory service. After the independent auditor has surveyed the fiscal records and identified the principal problems, it should be possible to develop an understanding on the scope of his audit and on the length of time which will be required for its completion. The independent auditor should then be in a position, if required, to give an estimate of the cost of the service which is not likely to be exceeded unless he encounters unforeseen problems.

This approach to the selection of an independent auditor, reflecting a legitimate concern for costs, is perfectly reasonable and acceptable. But no one gains—indeed, everyone is likely to lose—when auditors are selected by competitive bidding on the basis of the lowest possible price.

It would be in the best interest of all concerned for political subdivisions employing a certified public accountant or firm of certified public accountants to do so in the same way in which they would select an attorney, doctor, or other professional adviser—choose the one in whom they have confidence, discuss the work to be done, and agree on the basis for the fee. THE END

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# New York State Tax Forum

Conducted by PETER ELDER, CPA

## NEW YORK STATE FRANCHISE TAX LAW

Important amendments were recently enacted to the New York State franchise tax law. A summary of these changes is reported below:

### BUSINESS CORPORATIONS — TAXABLE UNDER ARTICLE 9-A

*Receipts (Sales) Allocation.* There has been a change in the method of allocating sales (receipts) from an exclusive point of origin to a partial point of destination basis. Prior to the change in law, in order to allocate receipts as arising from without New York State, it was necessary for a corporation to maintain a *permanent or continuous* place of business outside of New York. A permanent or continuous place of business has been defined as any bona fide office (other than a statutory office), factory, warehouse, or other space outside New York, at which the taxpayer is doing business in its own name in a regular and systematic manner, and which is continuously maintained, occupied and used by the taxpayer in carrying on its business through its regular employees regularly in attendance.

It may now be possible for a corporation to allocate some of its receipts if it maintains a *regular* place of business

outside of New York. (Note carefully the difference in the definitions of a permanent or continuous place of business and of a regular place of business.) A regular place of business has been defined to include any bona fide office, (other than a statutory office), factory, warehouse, or other space which is regularly used by the taxpayer in carrying on its business. Assuming compliance with this requirement, a corporation may now allocate 50% of receipts arising from sales of tangible personal property where:

1. Property is located within New York at the time of receipt of or appropriation to the orders where shipment is made to points outside of New York.

2. Property is located outside of New York at the time of receipt of or appropriation to the orders where shipment is made to points within New York. However, if such property is not located at a permanent or continuous place of business outside of New York at the time of receipt of or appropriation to the order, where receipt or acceptance of the order is in New York, the entire receipt is allocable to New York since shipment is made to points within New York.

3. Property is not located at time of the receipt of, or appropriation to the orders at any permanent or con-

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PETER ELDER, CPA, is chairman of our Society's Committee on New York State Taxation. Mr. Elder is a member of the firm of Peat, Marwick, Mitchell & Co.

tinuous place of business maintained outside of New York, where the orders are received or accepted within the State and where shipment is made between points outside of New York.

For purposes of items 2 and 3 an order will be deemed received or accepted in New York if it has been received or accepted by an employee, agent, agency or independent contractor chiefly situated at, connected with, by contract or otherwise, or sent out from a continuous place of business of the corporation within New York.

*Net Operating Loss Deduction.* It will now be possible to deduct a net operating loss for purposes of determining income subject to the franchise tax of 5½%. The amount of the deduction shall be the same as allowed under Section 172 of the Internal Revenue Code subject to the following limitations and adjustments:

1. It shall not include any loss incurred prior to a taxable year beginning January 1, 1961.

2. It shall not include any loss incurred during a taxable year in which a corporation was not subject to the franchise tax under Article 9-A.

3. It must be adjusted to reflect the inclusions and exclusions from income as provided by statute, but in no event, may it exceed the amount allowable under the Internal Revenue Code.

4. The loss may be carried back for three years and carried forward for five years.

5. The loss allowable is apportioned between investment income and business income in the proportion which each bears to entire net income, before such deduction, e.g., the year to which the deduction is carried back or carried forward.

*Other Changes.* • A deduction for tax imposed under Article 9-A will no

longer be permitted for purposes of determining entire net income.

- The tax on allocated subsidiary capital is at the rate of ½ mill without the former decreasing rates for such capital over \$50 million.

- The 15% minimum allocation rules as applied to investment and subsidiary allocation capital are no longer applicable.

- The 50% maximum allocation of subsidiary capital is no longer applicable.

- The statute of limitations is now three years unless income allocated to New York is understated by more than 25%, in which event the period is six years. An application for revision or refund may be filed within three years, instead of two years from the filing of the franchise tax report, or within one year from recomputation or assessment by the Commission.

*Effective Date of Changes.* All of the above changes are effective for taxable years beginning on or after January 1, 1961.

#### REAL ESTATE CORPORATIONS— TAXABLE UNDER ARTICLE 9

Section 182, Article 9 is repealed effective December 31, 1961. All real estate corporations become subject to tax under Article 9-A for periods beginning January 1, 1962.

As a result of such legislative reclassification of real estate corporations, a tax of 2% will be due on all dividends, as defined in the statute, paid during the calendar year 1961 and on the portion of the sum of the corporation's net worth in excess of its paid-in capital, as its assets in New York, exclusive of cash on hand and on deposit, bear to its total assets, exclusive of cash on hand and on deposit. Net worth shall not include any portion previously taxed under Section 182; any earned surplus of

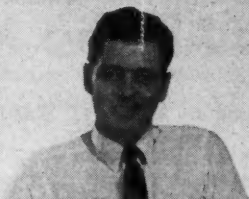
a corporation formerly taxed under Article 9-A and no deduction shall be allowed therefrom for dividends declared prior to and remaining unpaid on December 31, 1961. Net worth is to be valued as of December 31, 1961.

It should be noted that under prior law, when a real estate corporation was reclassified, the 2% tax was computed on actual net worth (usually fair market value) in determining the excess of net worth over paid-in capital. Since the amendment excludes the word "actual," it appears that the excess of net worth over paid-in capital should be determined by reference to the cost of assets less allowable depreciation, or fair market value, whichever is lower.

The above information is to be reported on a special form to be issued by the State Tax Commission. Such form must be filed on or before March 1, 1962. If the tax is in excess of \$25, it may be paid in two installments, one-half on March 1, 1962 and the balance on or before March 1, 1963. The statute provides that a reasonable extension of time may be granted by the State Tax Commission in which to pay the tax.

In the July 1960 issue of this magazine it was stated that I would serve as editor of this Department for one year. Since this month completes that period, I wish to express my sincere appreciation for the guidance and assistance received from the present and former Managing Editors, Max Block and Ben Newman. I also wish to thank Frederick J. McCarthy, with Peat, Marwick, Mitchell & Co. who so kindly and thoroughly reviewed all of the material published in the Department during my term as editor of the Department.

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# Accounting and the SEC

*Conducted by* LOUIS H. RAPPAPORT, CPA

## ACCOUNTING FOR DEFERRED COMPENSATION

A subject which has been receiving increasing attention recently from the SEC and the accountancy profession is the matter of deferred compensation plans. These plans are not a new phenomenon by any means, but recent changes in the arrangements—particularly as they provide for death benefits—have pointed up some of the accounting problems which arise as a consequence of the adoption of such plans.

A typical deferred compensation arrangement would provide for the employment of an executive for a period of say, ten years at  $x$  dollars a year. After such period, the plan would provide for compensation at a reduced rate for a period of, say, five years, during which period the executive agrees to make himself available for consultation and not to compete with the company in any way. A further provision in some agreements currently is to the effect that, if the executive should die during the consulting period, the company is required to pay his estate the same amount of money that it would have paid if he had lived. It thus becomes apparent

that at the date of his transition from the active to the so-called "consulting" period, the executive acquires substantial vested rights.

In many cases the obligation to render consulting services and not to compete does not impose any substantial obligation on the executive, nor does the company obtain substantial benefits therefrom. Furthermore, whatever benefits the company would obtain would cease if the executive were to die. On his death the company remains obligated to pay his widow or his estate, in return for which there would be no tangible benefit whatever to the company.

It would seem to us that, in this situation, the company should begin to make provision during the period of active employment for the payments to be made during the consulting period. If the amounts involved are material, this provision can be made net of the related tax effect in recognition of the fact that the payments during the consulting period are not deductible for tax purposes until the disbursements are actually made. The accrual for deferred compensation should be offset by a charge to income on the basis that the company is receiving now (that is, in the period of active employment) the benefit of payments to be made in the future (that is, in the consulting period). In other words, in conformity with the requirements of

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accrual basis accounting, income should be charged when the services are rendered—not when the payments are made.

On the other hand, this is not a matter where the accountant can proceed blindly on the assumption that the general rule is applicable in all cases. We have known instances in which an executive accepted reduced compensation during the consulting period where it was contemplated by both parties to the agreement that the consulting services would be genuine and would represent real value to the company. In a case in point, an executive accepted reduced compensation during the consulting period in return for reduced responsibilities. For such reduced compensation and with provi-

sion for death benefits, the company would continue to have access for a stated number of years, if the executive lived, to the man's abilities in matters involving, among other things, judgment, business connections, and "know how." These are not trivial matters, and, in the circumstances of the particular case, in order to have proper matching of costs and benefits, it seemed reasonable to charge income during the consulting period with all or an appropriate portion of the payments during that period. What if the man dies during the consulting period? In that case, the company would have no alternative but to provide at that time for the full amount of the remaining payments to be made to his widow or estate.

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# Administration of A CPA Practice

Conducted by MATTHEW P. GERAGHTY, CPA

## EFFECTIVE UTILIZATION OF AUDIT STAFF PERSONNEL

One of the most important factors in the successful operation of a Certified Public Accountant firm is the judicious utilization of the time and skills of audit staff personnel.

### OBJECTIVES TO BE OBTAINED

As in any other management function, it is well to keep in mind the objectives we hope to obtain, for otherwise we are likely to find that members of the same team are pulling in opposite directions.

Some of the more important objectives are:

- Continuity of personnel on recurring assignments
- Progressive development of staff personnel
- Equalization of travel time
- Suiting staff personalities to the job
- Matching staff abilities with job requirements
- Servicing clients promptly and efficiently
- Minimization of unassigned time

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MATTHEW P. GERAGHTY, CPA, is Chairman of the Committee on Administration of Accountant's Practice of The New York State Society of Certified Public Accountants. He is a partner in the firm of Alexander Grant & Company, CPAs.

### • Flexibility

All of these objectives deserve an additional word or two of explanation.

*Continuity in Assignments.* Assignments requiring two or more men should be staffed with an assistant who is, or will be capable of taking charge of the engagement in case the in-charge man is promoted, reassigned or leaves the firm. Resistance by the partner in-charge, and particularly the client, to such changes of in-charge responsibilities will be greatly lessened if some continuity exists. Needless to say such thinking requires careful long range planning in scheduling assignments.

*Staff Advancement.* A proper scheduling of audit assignments to provide audit staff personnel with diversification and depth in audit experience should permit a highly competent staff member to become a senior accountant within a period of three years or less. In achieving this objective, a man's first year duties would ordinarily be devoted to junior work. In his second year with the firm he should be given the opportunity to handle at least one or two small assignments by himself. If he handles such assignments in a competent manner he would then move progressively to in-charge responsibilities on larger accounts.

*Spreading the Travel Load.* Most married staff men have an aversion to travelling, a fact which may give the lie

to reports that accountants as a group are an unromantic lot. Be that as it may, the best that can be sought for in this area is an equitable distribution of the out-of-town work.

*Personality Considerations.* Needless to say, some staff men "hit it off better" with certain supervisors, partners and client personnel than they do with others. This sort of knowledge is gleaned from personal observations, from shop talk and gossip and from evaluation reports either written or oral. Obviously these differences in personalities and attitudes must be evaluated and if they are serious in nature they should be considered in mapping out the assignment program.

*Staff Selection.* Choosing the right man for the right job or segment of a job, requires an intimate knowledge of each staff man's experience and ability. To obtain this information, it is essential to establish sound evaluation procedures to provide a basis for measuring the continuing performance of each staff member.

*Servicing Clients.* Servicing the client's accounting and auditing needs promptly, efficiently, and economically is of course the principal function of a public accounting firm. To discharge this responsibility properly, it is imperative that assignments be entrusted only to qualified and competent staff persons with the various degrees of ability as required by the demands of the assignment. In addition, every effort must be made to program the assignment so as to meet the reporting deadlines established by the client.

*Complete Elimination of Unassigned Time.* Nothing less than the complete elimination of unassigned time, should be the goal of the individual responsible for scheduling assignments. To openly shoot for any goal less than this will weaken the resolve of every individual in achieving this objective. Un-

assigned time in this article means all time not spent in research, administration, staff training or in rendering services to clients. Even if it is the firm's policy to operate with a certain reserve percentage in staff strength, every effort must be employed to see that such reserve force is gainfully occupied. In this respect it is well to condition everyone in the firm to thinking the proper thoughts about unassigned time. If it is associated with the worst type of crimes, the conditioning may be considered successful.

*Flexibility.* A multitude of factors are always present to thwart even the most careful planning of assignments. Failure to meet completion dates on schedule, personal problems of staff men and internal and personal problems of the client make it almost impossible to schedule assignments definitively and precisely. Consequently, if unassigned time is to be kept to a minimum there must be considerable flexibility of thinking on the part of everyone in the firm, from the partner right on down to the newest staff member. It should be clearly understood by everyone that absolute rigidity in adhering to previous manpower commitments and to fixed time tables established by precedent or by subjective thinking on the part of the partner or client, often results in a wasteful utilization of staff time.

#### SCHEDULING MECHANICS

So much for the objectives to keep in mind in planning the effective utilization of manpower. What are the procedures to be adopted in carrying out such objectives?

The first step is to draft a rough assignment schedule for at least one year in advance. It is best to prepare this schedule prior to the start of the summer season, and, to include within the twelve month period the peak seasonal cycles of the firm. By adding one

month when each expired month is dropped, a continuous twelve month's forecast is available.

As an extremely helpful aid in preparing such a schedule, it would be advisable to prepare a schedule of assignments as actually carried out for the previous corresponding period of time. This schedule can be prepared from

the time reports for the previous year and the task itself may be delegated to an office clerk. Exhibit A illustrates how such historical assignment information is accumulated and one type of form that may be used for this purpose. It should be noted that this form is adaptable to the needs of both small and large firms.

[illegible]

EXHIBIT A

Using this historical information as a starting point and taking into consideration the objectives previously discussed and any additional information with regard to

- New clients
- Changes in fiscal years
- Changes in staff personnel

- Probable changes in starting dates of certain audits (last year's senior may be the new controller)
- Facts requiring a major increase or reduction in time
- Lost clients—for those who may have this experience
- Staff promotions

a rough assignment schedule for one year in advance should be prepared. The same form as previously referred to should be used except for the changes occasioned by current staff names and current dates. This project cannot be delegated to a clerk. In plotting the assignments write in the word senior, semi-senior or junior in the first column and on the same line as the client name, to indicate

- Shortages in manpower requirements

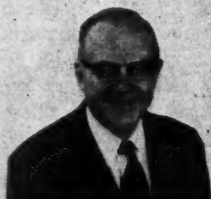
- Assignments on which decision is deferred until completion of the entire schedule

After considerable reworking and re-shuffling of staff personnel and assignments, a fairly good idea of the manpower requirements for the coming year is now available at least with respect to recurring audit assignments.

To make such a schedule, a workable tool for making manpower commitments to in-charge partners, staff personnel and clients, further steps must

be taken. At least a month prior to the scheduled starting dates of assignments, partners or managers in charge of clients should contact the client to confirm the scheduled starting dates. In addition, the partners or managers in charge of assignments from which personnel are to be released, must also be contacted to confirm the availability dates of such personnel. It is only after such information is reflected in the assignment schedules that manpower commitments can be made with any reasonable degree of accuracy. **THE END**

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# Payroll Tax Notes

Conducted by SAMUEL S. RESS, CPA

## WORKMEN'S COMPENSATION COVERAGE EXTENDED

The Workmen's Compensation Law has been amended this year, effective January 1, 1962 so as to extend its coverage to include establishments having only one person in their employ. This expansion of insurance coverage for accidents incurred in the course of employment will cover approximately 50,000 more employees and employers in New York, including accounting firms with only one employee. (Chapter 233, Laws of 1961).

## ADDITIONAL UNEMPLOYMENT INSURANCE BENEFITS

Last February, there was enacted a N. Y. State law conditionally extending benefits for an additional 13 weeks. This law was repealed and was replaced by a non-conditional measure. The Industrial Commissioner was authorized to enter into an agreement with the United States enabling New York State to pay up to an additional 13 weeks of unemployment insurance benefits to those who have exhausted their regular 26 week period of benefits. This law, known as Chapter 194 of the Laws of 1961, became effective on March 26, 1961. The additional benefits commenced during the week

of April 17th, 1961 and will end April 1, 1962. The extension is federally financed by a recently enacted increase in the Federal Unemployment Tax of 0.4% on taxable payrolls for a two year period.

## MEDICAL ASSISTANCE TO AGED

A program to supply institutional and non-institutional medical benefits to 170,000 needy aged persons annually is authorized by Chapter 195 of the Laws of 1961 (N. Y. State), effective April 1, 1961.

The bill is planned for possible integration with, or supplementation of any Federal program for similar relief. Under this measure, New York will be able to utilize annually \$47,500,000 in Federal funds appropriated last year. The Federal government pays for half of the program, with the State and the localities equally sharing the balance.

The benefits provided under this measure include physician's services, care, treatment, maintenance and nursing services in hospitals, nursing homes, infirmaries or other medical institutions. Outpatient hospital or clinic services, and when prescribed, home nursing services, drugs, sick room supplies, prosthetic appliances and physical therapy are allowable benefits.

To be eligible for this assistance, a person must be 65 years of age or older, a resident of this state with income or resources insufficient to meet all the costs of required medical care. No enrollment fee, premium or similar charge is required, and there are no

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employer or employee contributions provided for by this measure.

In determining the insufficiency of income and resources of benefit claimants, all income including any available support from responsible relatives, in excess of \$1,800 for a single person and \$2,600 for a married couple must first be applied toward the payment of medical expenses. Similarly liquid assets must not exceed \$900 for a single person and \$1,300 for a married couple. To encourage the purchase of voluntary health insurance, an exclusion from income and assets is allowed for expenditures for such insurance. The amount of the exclusion is limited to \$150 a year for a single person and \$250 a year for a married couple.

This program will be administered locally by the Public Welfare office of the county, city or town in which the claimant resides.

#### EXPERIENCE RATING CHARGE PROTESTS BARRED IF NOT TIMELY MADE

On March 3, 1961, the employer in Appeal Board Case Number 79,949-61A applied for a reconsideration and reopening of a decision holding that a claimant was eligible to receive benefits without disqualifying conditions because of the employer's failure to make a timely protest thereto.

The employer was late in protesting the original determination which granted the benefits because the protest had been filed more than 30 days after the determination date. The delinquent protest was made by the employer when he received the "Notice of Experience Rating Charges" which included charges to the employer's account for benefits paid by the New York Unemployment Insurance Fund which might not otherwise have been paid had the employer filed a timely protest.

The referee held that the initial de-

termination of eligibility without disqualifying conditions remained in effect because the employer had failed to make a timely protest. The employer pointed out that the decision was in conflict with an earlier decision of the Appeal Board, in case number 51,745-55, wherein it had been held that an employer was not bound by the limitation set forth in Section 620.1(a) of the Unemployment Insurance Law on the theory that Section 581.1(e) of the law superseded the time limitation contained in Section 620.1(a). The Board agreed that there was a conflict. However, the Board decided that in the light of the decisions of the Court in *Matter of Ferraioli*, 7 App. Div. 2nd 819, reversing Appeal Board case number 59,665-59, and *Matter of Adinolfi*, 10 App. Div. 2nd 393, reversing Appeal Board case number 61,241-57, they are constrained to abandon the principle enunciated in the earlier decision.

Heretofore it had been ruled that until such time as the employer's account was charged with the benefit payment, the employer's opportunity to protest the payment of a benefit claim remained open until after the expiration of 20 days from the date of the Notice of Experience Charges to the employer with the questionable benefit item stated thereon. It is important to note however that the Industrial Commissioner continues to have the power to review an initial determination in the event he obtains new information which satisfies him that an error had been made in the original determination. Such new determination must be issued within one year from the date of the original determination.

This decision is another reason why employers should tighten their procedures and unemployment insurance controls to prevent unwarranted charges to their accounts.



# Federal Taxation

*Decisions and Rulings*—RICHARD S. HELSTEIN, CPA

*Commentary*

—Committee on Federal Taxation  
Chairman, ARTHUR J. DIXON, CPA

## DECISIONS AND RULINGS

### LIQUIDATION OR REORGANIZATION? CAPITAL GAIN OR DIVIDEND?

A recently decided case highlights the constantly increasing scrutiny to which capital gain resulting from Subchapter C transactions, is subjected. Although this case fell within the 1939 Code, the decision is equally significant under present law.

The taxpayer, Walter Morgan, was sole stockholder of both X and Y corporations. The former corporation rendered investment advisory services to the Wellington Fund; the latter rendered investment promotional services to the Fund. The Fund believed it could obtain *both* services less expensively from *one* of these corporations. (The taxpayer was also .003% stockholder in the Fund and Chairman of its Board of Directors.) Accordingly, Wellington Fund's contract with X Company for advisory services was terminated and a similar contract with Y Company entered into. At the same time, the taxpayer arranged a sale by X Company of its operational assets to Y Company at fair market value. These assets included certain files, research data and office fixtures and equipment. The employees of X Com-

pany also became employees of Y Company. Thus, Y Company was able to continue to provide Wellington with the services that X Company had previously rendered it.

Simultaneously with the sale of assets from X Company to Y Company, the taxpayer liquidated X Company, and received, as its sole stockholder, \$214,000 of cash and government securities. He reported his \$212,000 *gain* on this liquidation as capital gain from a complete corporate liquidation. The Commissioner argued, however, that there was no liquidation but rather a "(D)" reorganization. That is, X Company transferred part of its assets to Y Company and, thereafter, the stockholder of X Company was in control of Y Company. Consequently, the Commissioner reasoned that the \$214,000 received by taxpayer was "boot" taxable as a dividend under the predecessors of Sections 354 and 356 (1954 IRC).

The taxpayer countered by arguing that before a transaction falls within the predecessor of Section 356 (the "boot" section) there must be an exchange of stock for stock (present Section 354) and since he did not re-

ceive any additional stock from Y Company, he did not met the technical exchange requirement. Therefore, the distribution was simply in liquidation of X Company and taxable as a capital gain. The Tax Court agreed.

The Third Circuit, reversing the Tax Court, reasoned that since the taxpayer-stockholder of X Company was the sole stockholder of Y Company, it would have been meaningless for him to take additional stock in Y Company. Thus, the net effect of the transaction amounted to a reorganization with a dividend to the taxpayer in the amount of the cash and securities received. (*Walter L. Morgan* CA-3, 3/21/61).

Under the 1954 Code the result of the Morgan case might be somewhat more difficult to reach. Thus, not only must there still be an exchange of stock for stock (Sec. 354(a)), but, the transferor corporation must transfer substantially all of its assets to the transferee corporation (Sec. 354(b)(1)(A)). In the facts of Morgan, \$214,000 of X Company's assets were not so transferred, but were distributed to Morgan. Of course, the Treasury could argue that in effect *all* of the assets *were* transferred, and the reorganized company distributed the liquid assets as a dividend; or that the distribution preceded the transfer to Y, therefore all of the assets of X were transferred. Thus, the rule of the Morgan case remains equally dangerous under present law for those who wish to bail-out liquid assets via the liquidation-reincorporation route.

For example, suppose there were a distribution in liquidation of the X corporation of *all of its* assets, followed by

a sale by the stockholders of the operating assets to Y corporation. Under the "net effect" rationale of the Third Circuit, this transaction, too, might be held to be a "(D)" reorganization and a "dividend" result would again obtain. If, as in Morgan, the transferred business is to be continued, it would seem better to keep the transferor corporation alive as an investment vehicle and have it retain its non-business assets. Then if it were deemed desirable to liquidate after 3 to 5 years, such a time interval should probably be enough to preclude application of the step transaction rule—and this would help assure a capital gain result.

#### PARTIAL RENTAL OF BUILDING IS NOT A BUSINESS

All of the stock of a corporation was owned by the taxpayer and his wife. The corporation derived its income from an insurance business, a real estate brokerage business, and from the rental of part of a two story building which it owned (the balance of which was occupied by the corporation). As the insurance and real estate brokerage business grew, the corporation took over more space in the building and ultimately it occupied 50 percent of the floor space. The balance was rented to four tenants.

In 1955 another corporation was created to which was transferred the building and land in exchange for all of the capital stock. The transferor corporation leased back the building and land. The stock in the new corporation was distributed to the taxpayer and his wife.

The taxpayers treated this as a non-taxable distribution in a "spin-off" under Section 355.

The Court denied this. It pointed out that the requirements of Section 355-(b) were not met because the rental of part of the building was incidental

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**RICHARD S. HELSTEIN, CPA**, has been a member of our Society since 1940. He is chairman of the Committee on Publications and was formerly a member of the Committee on Federal Taxation. Mr. Helstein is associated with J. K. Lasser & Co.

and not the "conduct of a trade or business." The rentals received from other tenants were far less than the receipts from the taxpayer's other businesses and even less than represented by the percentage of space leased i.e., although the taxpayers' business occupied only 50% of the premises, it paid 70% of the gross rentals. Citing the examples in the Regulations and the case of *Isabel A. Elliott* (32 TC 283), the Tax Court ruled in favor of the Commissioner. (*Appleby* 35 TC—No. 86).

#### SHUT-IN PAYMENTS ON OIL AND GAS LEASES NOT SUBJECT TO DEPLETION

The taxpayers had leased property to Superior Oil Company under a lease which provided, inter alia, that if any wells were capable of producing oil or gas, but were not used, a certain fee was to be paid during the time the wells were inactive. The fee was denominated as \$5 per acre rental and covered certain stated acreage in the vicinity of each well. The lease also provided that Superior would pay the taxpayer \$5 rental for other acreage leased.

Because of the surplusage of oil, and the conditions in the market, Superior, although it had completed 4 wells, did not use them. Accordingly, it paid the taxpayers approximately \$40,000 per year covering the rental payments and the royalty payments (the royalty payments representing the rental of the area around the non-producing wells).

The taxpayers claimed depletion at 27½% of the entire payments. The District Court held that the taxpayers were entitled to depletion only upon the "royalty" payments, but not upon the rental payments for the acreage not contiguous to the wells. The taxpayers appealed on the grounds that all of the payments were subject to depletion. The Government appealed

on the grounds that none of the payments were subject to depletion.

The Court of Appeals in the 5th Circuit upheld the Government. It pointed out that the essential factor in the allowability of depletion is the exhaustion of the mineral properties. Since the wells were not being operated, there was no extraction or exhaustion, and thus no depletion of capital. (*Johnson et al v. Phinney* CA-5 3/15/61).

The Court in reaching its conclusion relied upon the statement by the Supreme Court that . . . "mineral depletion for tax purposes is an allowance from income for the exhaustion of capital assets." (*U.S. v. Cannelton Sewer Pipe Co.*, 1960, 364 U.S. 76 and its own decision in *Schofield v. LaGloria Oil and Gas Co.*, 1959, 268 F(2d) 699, cert. den. 361 US 933). It distinguished the case where bonus payments were held to be depletable on the grounds that such payments were made in contemplation of production and "represent added payments for such production as later results."

#### NO INCOME RESULTS FROM INTEREST-FREE LOANS

There have been numerous cases which have held that where individuals are permitted to use corporate owned property, such as a house, without paying rent therefore, taxable income accrues to the individual to the extent of the fair rental value of the house. However, this doctrine now has been specifically held not to apply to the use of corporate funds by individuals.

The taxpayers were stockholders in a corporation which loaned them in excess of two million dollars over the years 1955 and 1956. The taxpayers paid no interest to the corporation for the use of these funds, and the Commissioner claimed that the taxpayers realized income to the extent of the

prime rate of interest which they would have had to have paid had they borrowed money from a non-related source. The Tax Court disagreed. It held that had the taxpayers paid interest to the corporation, such interest would have been deductible, so that the net result would have produced no taxable income.

There were four dissents. In one of the dissents it was pointed out that, had the loans been used to purchase tax exempt bonds, the interest payments thereon would not have been deductible. The dissenting opinions also disagreed with the majority hold-

ing that the interest is not in the same category as rent, because the rent would not have represented a deductible item (as held in prior cases), by pointing out that if the rent were for business property, it would certainly have constituted a deductible item. Thus, the dissenters contend, that in this, a case of first impression, a broad general rule should not have been promulgated, because the results might be altered by the use to which the borrowed funds were put; in other words, each case should be governed by its particular set of facts. (*J. Simpson Dean* 35 TC—No. 113).

## COMMENTARY

### ELIGIBILITY OF SUBCHAPTER S CORPORATION SHAREHOLDERS FOR SOCIAL SECURITY BENEFITS

Does a shareholder, eligible for social security benefits, who receives no salary from a Subchapter S corporation even though he renders services to the corporation, remain eligible for social security benefit payments? This question was the subject of recent correspondence between a member of our Committee and the Assistant Director of the Bureau of Old Age and Survivors Insurance of the Social Security Administration. A condensation of the divergent views is submitted to alert practitioners to the possibility that their seemingly logical advice to clients may encounter official resistance.

*Affirmative View (as expressed by a member of our Committee).* A stockholder (age 65 or over) of a Subchapter S corporation who draws no salary should be eligible for social security benefits, even though a sole proprietor or partner (over 65 but less than 72) is ineligible if he renders substantial services as a self-employed person. There is an important difference be-

tween an employee (including a stockholder) of a corporation and a self-employed partner or sole proprietor in determining what constitutes earned income for the retirement test. A self-employed person with earnings over \$1,200 a year loses some or all of his benefits for any month during which he renders substantial services. An individual who works for a corporation forfeits his benefits, not because of the services he renders, but only if he receives wages of more than \$100 a month. The substantial services test does not apply to him. In each case, of course, the amount of benefits lost is determined under a formula based on total earnings for the year.

If a corporation makes an election under Subchapter S, it changes its status for income tax purposes but otherwise it remains a corporation. Its stockholders do not become self-employed persons and their eligibility for social security benefits must be determined under the rules governing employees.

There is nothing to prevent a stockholder who has reached retirement age from rendering services to the corporation without compensation if he

so desires, regardless of whether an election has been made under Subchapter S. If the younger stockholders draw reasonable salaries but the stockholder who is over age 65 receives no compensation, even though he may perform what could be called substantial services, there is no reason why he should be charged with earned income simply because he receives his proportionate share of any dividends paid based upon stock holdings.

To say that under such circumstances even the undistributed income of a Subchapter S corporation can be treated as earned income of a stockholder ignores the fundamental relationship between a corporation and its stockholders. The election under Subchapter S shifts the tax on the income from the corporation to the stockholders but gives the stockholders no right to the undistributed income which can be paid to them only if a dividend is declared by the directors. To treat such undistributed income as remuneration for services would be to ignore the facts of the situation.

*Negative View (the position taken by the Social Security Administration).* In deciding whether particular amounts constitute earnings for services performed by a beneficiary, the Social Security Administration is not bound

by the name given to a particular amount which the beneficiary has earned as an employee or derived as a self-employed person. Consequently, as an individual case arises, the Bureau of Old Age and Survivors Insurance reserves the right to look into the surrounding facts to determine the true nature of the income. If the evidence shows that an amount is wages earned or net earnings from self-employment derived during the particular taxable year under consideration, it is counted as earnings for retirement test purposes for that year. On the other hand, if it is found that amounts received by the beneficiary are investment income such as dividends from stock, interest, or the like (as distinguished from compensation for services performed in a business), the amounts are not counted as earnings for retirement test purposes. This same principle applies to both distributed and undistributed profits of a corporation which has elected under Subchapter S not to pay corporate income tax.

Because wages are counted as earnings for retirement test purposes in the period in which they are earned (as distinguished from the period in which the compensation is paid), a stockholder of a Subchapter S corporation is not in a better position (to receive benefit payments) than a self-employed person if he merely elects to defer receipt of his salary until some future time. For the same reason, no benefits would be payable to a beneficiary-employee who rendered valuable services for an electing corporation which derived greater net profits because he purportedly worked for no salary (or for a salary which was unrealistic when all the facts were considered). In such case the net profits of the corporation, distributed or undistributed, would in effect contain all (or part) of his

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salary simply because the corporation failed to deduct his salary as a business expense. Accordingly, whether the amounts are paid to the beneficiary or are held in the corporation for his benefit, he has not rendered services without compensation; instead, his earned wages are being labeled as dividends or the like. Thus, these are not beneficiaries who have retired; they have not ceased to render personal services in business and are continuing to derive substantial income from those services.

The limitation on earnings applies to all wages earned in employment and all net earnings from self-employment. It is significant to note that employees' wages are counted as earnings for the period in which the services were performed but that net earnings from self-employment are counted as earnings in the taxable year in which they are derived (depending upon the accounting method used in reporting income for tax purposes).

The question was also asked as to what the result would be where the stockholders of a corporation do not elect under Subchapter S to be taxed individually rather than to pay corporate income tax. Where an employee of a non-electing corporation earns wages exceeding the allowable amount, benefit payments must be withheld even though arrangements are made to defer payment of the salary until some future period. Here again, wages are counted when earned and not when paid.

#### ESTATE TAX ALTERNATIVE VALUATION OF JOINTLY OWNED PROPERTY

The gross estate of a decedent is normally valued for estate tax purposes as of the date of death. However, Section 2032 grants to the executor the option of using an alternative valuation date. If adopted, property sold, exchanged, distributed or otherwise

disposed of within one year after the decedent's death will be valued as of the date of such disposition. Property included in the gross estate which had not been disposed of within one year after the date of death, is valued as of the date one year after death under Section 2032.

The question has been raised as to the proper alternative date in the case of jointly owned property. Where the right of survivorship exists, jointly owned property passes to the surviving spouse or other joint tenant on death. What is the proper alternative valuation date for such property?

Let us assume the following facts: Mr. A died on April 1, 1960. Included in his gross estate were stocks and bonds held in joint name with his wife (with right of survivorship) which were valued as of the date of death at \$100,000. The certificates representing these securities were actually transferred to the surviving spouse on June 1, 1960, at which date their market value was \$110,000. The surviving spouse sold all of these securities on November 1, 1960 for \$120,000. Let us further assume that these jointly held securities properly belonged in the gross estate for tax purposes since no part of their acquisition cost was attributable to the surviving spouse. The executor elected to use the alternative valuation date in valuing the gross estate. At what value should these jointly held securities be entered on the estate tax return?

The answer to this question depends upon when a sale, exchange, distribution or other disposition occurred. The automatic transfer of legal title to these securities to the surviving spouse on death did not constitute a sale or Distribution. Neither did the physical transfer of the securities to her. Although this is not stated in the law, the Regulations imply this to be true. Reg.



20.2032-1(c)(3) states that property may be sold, exchanged, or otherwise disposed of, not only by the executor but also by others including a surviving joint tenant or tenant by the entirety. It then goes on to say that when a binding contract for the sale, exchange or other disposition is entered into, the property is considered as sold on the effective date of the contract. In our problem, the first sale, exchange, distribution or disposition after death was the sale by the surviving spouse on November 1, 1960. Thus, the jointly owned securities should be valued for estate tax purposes at \$120,000, the value on the alternative date prescribed by Section 2032.

The rules for determining the alternative valuation date are not only applicable to property included in the probate estate, but, as indicated above, also apply to property passing on death outside of the will. These same rules are applicable to property included in the gross estate which was transferred prior to death. Thus, for example, a gift in contemplation of death would be valued under Section 2032 on the date one year from the date of death, if such property was still held by the donee on that date, or on the date of sale or other disposition, if the property was disposed of within one year after death.

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DEDUCTION FOR DISQUALIFYING  
DISPOSITION OF STOCK ACQUIRED  
UNDER RESTRICTED STOCK OPTION

Section 421(a) of the 1954 Code provides generally that no deduction is allowable to a corporation with respect to a restricted stock option which has been granted to an employee.

However, this rule does not apply if the stock acquired pursuant to a restricted stock option is disposed of by the employee within two years from the

date of the granting of the option or within six months after the transfer of the shares to him. Such a disposition is called a "disqualifying disposition." In such an event, the general rule, set forth in Section 421(f) and in the applicable regulations, is that the employee thereupon realizes compensation to the extent of the difference between the value of the stock at the time acquired and the option price, and that the corporate employer becomes entitled to a deduction of equivalent amount.

Employees usually try to avoid a disqualifying disposition because of the additional tax burden which results. However, numerous disqualifying dispositions occur for a number of reasons. For example, the employee may be more concerned about the future market price of the stock than he is about the tax consequences of a disqualifying disposition; he may need the cash to meet personal emergencies or to undertake other ventures; or he may simply be unaware of the meaning and significance of a disqualifying disposition. Whatever the reason, the corporation is entitled to a deduction merely because the disqualifying disposition has been made.

A disqualifying disposition is apt to be overlooked because no immediate business or accounting action is ordinarily necessitated by a transfer of shares from one stockholder to another. In many corporations, the stock transfer functions are conducted by persons, such as the secretary, who do not participate in accounting and tax matters. If an independent stock transfer agent and registrar is used, the corporation will ordinarily not receive this information unless specific arrangements are made. In some cases, the stock acquired may be placed by the employee in a "street name," and the corporation, or its transfer agent and registrar



would have no way of ascertaining if the stock had been disposed of.

One method to secure the information would be to send a questionnaire to every employee who has exercised a restricted stock option six months after such exercise. Even this suggestion presents questions of corporate policy which may render it inadvisable. Obviously, each corporation must determine for itself what method is to be used. Those charged with the responsibility of preparing the corporation's federal income tax return must seriously consider the problem.

#### WIDOW'S RETIREMENT CREDIT

Section 37 of the 1954 Code provides a limited credit against tax for certain U. S. citizens or residents who receive "retirement income." In order to be eligible for the credit, it is necessary that the taxpayer (or in the case of a widow or widower, the taxpayer's spouse) have received earned income of at least \$600 in each of any 10 prior years.

The term "earned income" is defined by reference to Section 911(b) which deals with earned income of U. S. citizens working abroad. Accordingly, earned income includes

wages, salaries, and other amounts received as compensation for services. However, there is no requirement that the earned income must have been includible in gross income in order for the taxpayer or spouse to be eligible for the retirement credit.

Thus a U. S. citizen who is the widow of a nonresident alien would be eligible for the credit even though the husband's earned income had never been subject to U. S. income tax and he would not himself be eligible for the credit. The credit also would be available to a U. S. citizen whose earned income had not been subject to tax because it had been received while he was a bona fide resident of a foreign country or while he was present in a foreign country for a period of 17 out of 18 months.

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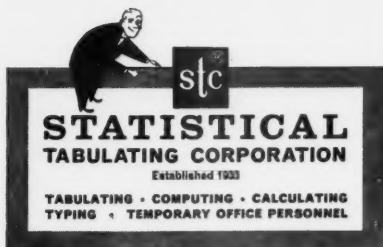
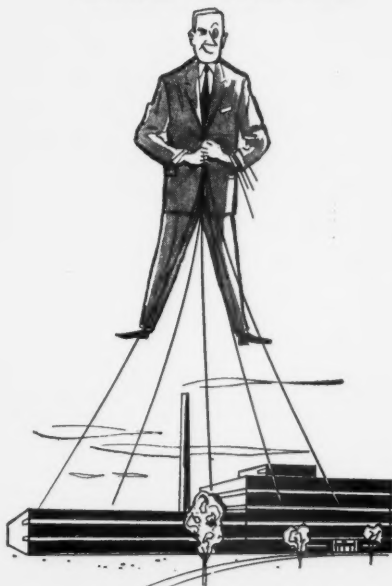
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